88-1003

No.

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1988

COLONIAL SAVINGS ASSOCIATION and SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT (AND APPENDIX)

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75 pp

QUESTION PRESENTED

When a depositor in a financial institution forfeits a portion of his or her deposit in order to receive back the balance of that deposit prior to its maturity date, is the income resulting to the institution on account of such forfeiture "income by reason of the discharge. . .of indebtedness" within the meaning of Section 108 of the Internal Revenue Code?

REQUEST FOR DEFERRAL OF CONSIDERATION OF PETITION

As described at pp. 8-10, *infra*, the decision of the Seventh Circuit Court of Appeals in this case is in direct conflict with the decision of the United States District Court for the Northern District of Texas in *Centennial Savings Bank FSB v. United States*, 682 F.Supp. 1389 (D.C.N.D. Tex. 1988). The District Court decision is currently on appeal by the United States to the United States Court of Appeals for the Fifth Circuit, raising the likelihood that there will be a conflict between the Seventh and Fifth Circuits on the issue presented above. Oral argument in the Fifth Circuit is expected to be held by late Spring, 1989.

Because of the reasonably imminent likelihood of a conflict between the Circuit Courts of Appeal on an issue that effects thousands of savings institutions across the country, see *infra*, at p. 4, it is respectfully requested that this Court defer consideration of this Petition for Certiorari until the Fifth Circuit issues a decision in *Centennial*.

LIST OF PARTIES AND RULE 28.1 LIST

The parties to the proceedings below were the petitioner, Colonial Savings and Loan Association and Subsidiaries, and the respondent, the Commissioner of Internal Revenue. Frontier Savings and Loan Association ("Frontier") was also involved in the proceedings below, but on an issue not addressed in this Petition. Thus, Frontier is not named as a party herein.

The Petitioners, Colonial Savings and Loan Association and Subsidiaries have no corporate stockholders, subsidiaries (other than wholly owned subsidiaries) or other affiliates.

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In The

Supreme Court of the United States

October Term, 1988

COLONIAL SAVINGS ASSOCIATION and SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

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The Petitioners, Colonial Savings Association and Subsidiaries, respectfully pray that the Court (1) defer consideration of this Petition until the Fifth Circuit Court of Appeals issues an opinion on a case, *Centennial Savings Bank FSB v. United States*, 682 F. Supp. 1389 (D.C.N.D. Tex. 1988) presenting the identical issue presented herein and reaching an opposite conclusion on that issue, and (2) in any event, grant this Petition to review the judgment and opinion of the United States Court of Appeals for the

Seventh Circuit, entered in the above-entitled proceedings on August 10, 1988.

OPINIONS BELOW

The opinion of the Court of Appeals for the Seventh Circuit is reported at 854 F.2d 1001 (7th Cir. 1988) and is reprinted in the Appendix, p. A-1.

The opinion of the United States Tax Court is reported at 85 T.C. 855 (1985) and is reprinted in the Appendix, p. A-27.

JURISDICTION

The Seventh Circuit Court of Appeals entered a judgment and opinion on August 10, 1988, holding that early withdrawal penalties do not constitute "income from discharge of indebtedness" under I.R.C. §108. On September 13, 1988, the Seventh Circuit issued an order denying Petitioners' timely filed Petition for Rehearing and Suggestion for Rehearing En Banc. Appendix, p. A-50.

The jurisdiction of this Court to review the Judgement of the Seventh Circuit is invoked under I.R.C. § 7482 (a)(1) and 28 U.S.C. §1254(1).

FEDERAL STATUTE

INTERNAL REVENUE CODE (26 U.S.C.)

Sec. 108 [as amended by Secs. 1906(b)(13)(A), 1951(b)(2)(A), Tax Reform Act of 1976, Pub L. No. 94-455, 90 Stat. 1520]

INCOME FROM DISCHARGE OF INDEBTEDNESS

No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if–

(1) the indebtedness was incurred or assumed–

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction.

STATEMENT OF THE CASE

The facts of this case were fully stipulated.

The Petitioners are Colonial Savings Association ("Colonial") and its subsidiaries, which filed a timely consolidated federal income tax return for their taxable year ending June 30, 1980. Respondent Commissioner of Internal Revenue (the "Commissioner") issued a notice of deficiency with respect to that tax return, resulting in part from the Commissioner's determination that Colonial had improperly elected to exclude certain amounts from its income under I.R.C. §§108 and 1017, as in effect for the taxable year in question.[1] The United States Tax Court (whose jurisdiction to review the Commissioner's notice of deficiency was invoked under I.R.C. §6214) and the United States Court of Appeals (whose jurisdiction to review

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[1] The Commissioner also determined that Colonial had improperly excluded from its income certain stock dividends received by it during the year from the Federal Home Loan Bank of Chicago. While the instant case was pending before the Tax Court, the parties stipulated that the Court should decide the stock dividend issue in the same manner as the Court might

(Footnote continued on the following page)

the Tax Court's decision was invoked under I.R.C. §7482) agreed with this determination and it is the correctness of their conclusions on this point which is the subject of this Petition. According to a Brief filed with the Court of Appeals by the United States League of Savings Institutions as Amicus Curiae, the same issue is presented in the returns of thousands of savings institutions in the country, so that the instant appeal constitutes a "test" case with respect to this issue.[2]

Colonial is a Wisconsin mutual savings and loan association. During its taxable year ended June 30, 1980, it had various types of savings account outstanding, differring from each other in term, interest rate and other particulars. Interest on each of the accounts in question was computed on a daily basis and added each day to the depositor's account. The parties agree that, on any given date, there was a bona fide and binding debt owed by Colonial to each depositor, equal to the principal amount of the deposit plus all interest accrued (but not yet withdrawn) through that date.

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1 *(continued)*
ultimately decide the identical issue presented in the then pending case of *Frontier Savings and Loan Association v. Commissioner*, 87 T.C. 665 (1986). The Court decided the *Frontier* case in favor of the taxpayer therein and, pursuant to the stipulation just described, similarly decided the stock dividend issue in favor of the Petitioner herein. The Commissioner appealed the *Frontier* case and, after Colonial appealed the Tax Court's decision with respect to the issue presented in the instant appeal, the Commissioner cross-appealed on the stock dividend issue. Because the stock dividend issue was presented in both cases, the two appeals were consolidated and, on August 10, 1988, the Court of Appeals decided that issue in favor of both taxpayers. As of this date, the Commissioner has not filed a petition for certiorari from that decision.

[2] Brief of the United States League of Saving Institutions as Amicus Curiae, p.2.

During the year at issue, numerous depositors withdrew their deposits prior to the maturity dates thereof. The parties agree that the vast majority of such withdrawals were motivated by rapidly increasing interest rates and, in the vast majority of instances, the remitted amount was promptly deposited by the depositor with Colonial in an account paying a higher rate of interest. When a depositor withdrew the balance in any account prior to the account's maturity, the depositor was required by federal regulations to forefeit a portion of the amount owed to it. See 12 C.F.R. §526.7(a) (1979) and 12 C.F.R. §526.7(a) (1980). The amount of this forfeiture was prescribed by these same regulations.[3]

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[3] For the relevant tax year, the early withdrawal penalty regulations provided two different possible penalties. For accounts opened before July 1, 1979, the pertinent penalty was as follows:

> For any certificate account issued after October 31, 1973. . . . , a member shall impose the following conditions on any withdrawal before the end of the term or qualifying period: (1) The account holder shall receive interest or dividends from the date of issuance of the account on the amount withdrawn at a rate not exceeding the rate being paid on regular accounts; and (2) the account holder shall pay a penalty of at least (i) the interest or dividends at such rate for 90 days (3 months) on the amount withdrawn or (ii) all interest or dividends at such rate (since issuance or renewal of the certificate account) on the amount withdrawn.

12 C.F.R. §526.7(a) (1979). For accounts opened after June 30, 1979, the relevant penalty was as follows:

> For any certificate account issued, extended, or renewed after June 30, 1979, a member shall impose (except as paragraph (c) of this section provides) the following conditions on any withdrawal before the end of the term or qualifying period:
>
> (1) If the term or qualifying period is one year or less, the account owner shall pay a penalty on the amount withdrawn of at least 90 days (3 months) earnings on the account. If the amount withdrawn has remained on deposit for 3 months or less, all earnings shall be forfeited.

This forfeiture was uniformly handled by reducing the amount otherwise payable to the depositor by the amount of the forfeiture, remitting only the balance to the depositor and (in those circumstances where the "withdrawn" balance was to be redeposited with Colonial) accepting that balance as the opening deposit in another account.

Colonial, for federal income tax purposes, generally treated the early withdrawal forfeitures as income arising from the discharge of indebtedness.[4] It therefore excluded the forfeitures from its gross income under I.R.C. §108[5] and, having made a timely election as permitted by that Section, reduced the basis of its other assets under I.R.C. §1017. [6]

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3 *(continued)*

> (2) If the term or qualifying period is more than one year, the account owner shall pay a penalty on the amount withdrawn of at least 180 days (6 months) earnings on the account. If the amount withdrawn has remained on deposit for 6 months or less, all earnings shall be forfeited.

12 C.F.R. §526.7(a) (1980).

[4] For a short period at the beginning of its taxable year ended June 30, 1980, Colonial did not treat the early withdrawal forfeitures in this manner. This was in error and neither the Tax Court or Court of Appeals found this mistake to be of any relevance.

[5] All references in this petition to the "I.R.C." are to the Internal Revenue Code as in existence during the taxable year here at issue, that is, the twelve-month period ended June 30, 1980. I.R.C. §§108 and 1017 have been amended several times since that year, but the amendments do not bear on the issue presented in this appeal. Currently, the benefits of I.R.C.. §§108 and 1017 are limited to discharges occurring in a case under Title 11 of the United States Code (relating to bankruptcy) or when the taxpayer is insolvent, but no such limitation existed during the period here at issue.

[6] This basis reduction has the consequence of increasing the income of the taxpayer/debtor in later years, because of reduced depreciation deductions and/or larger gains (or smaller loses)

(Footnote continued on the following page)

The Commissioner, in his notice of deficiency, determined that the forfeitures did not constitute "income by reason of the discharge . . . of indebtedness" and included the entire amounts thereof in Colonial's income for its taxable year ended June 30, 1980 (the year in which the withdrawals took place).

Colonial filed a timely Petition with the United States Tax Court and that Court issued its opinion on November 26, 1985, concluding that the Commissioner's determination was correct. The Tax Court accepted the Commissioner's argument that I.R.C. §§108 and 1017 are available only to "pure" debt discharges and not to transactions in which the forgiveness of debt is merely a method by which the debtor pays a "separate and distinct" obligation to its creditor. Applying that rule to the instant case, the Tax Court found that the forfeiture or penalty [7] required of a depositor on account of an early withdrawal constituted a "separate and distinct" obligation owed by the depositor to the institution and that the reduction in the institution's debt obligation was merely a method by which the depositor satisfied its own obligation.

Colonial then filed a timely appeal to the United States Court of Appeals for the Seventh Circuit, which rendered its decision on August 10, 1988, affirming the Tax Court. The Court of Appeals concluded that the debt discharge involved in this case is merely a means by which the depositor satisfies its own separate obligation to the financial institution, that is, the penalty imposed upon a person making an early withdrawal from an account in order

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6 *(continued)*
when the assets are sold. The relief provided by I.R.C. §§108 and 1017 is therefore a matter of timing, enabling a taxpayer/debtor which realizes income from the forfeiture of its debt to defer recognition of that income until later years.

[7] The Tax Court agreed that the "forfeiture" versus "penalty" nomenclature had no legal relevance.

to compensate the institution for the "damages" caused to it by that withdrawal. The Court stated that such a transaction "cannot be described as a typical Section 108 transaction," that Congress knew of the controversy since at least 1973 on account of the Commissioner's issuance in that year of Rev. Rul. 73-511, 1973-2 C.B. 402 and that Congress' failure to take any action since 1973 indicated its approval of the Commissioner's position. Colonial then filed with the Court of Appeals a timely Petition for Rehearing and Suggestion for Rehearing En Banc, arguing that the Court had seriously misinterpreted Rev. Rul. 73-511 (which had not been discussed to any relevant degree either in the briefs filed with the Court or at oral argument). The Petition was denied on September 13, 1988.

REASONS FOR GRANTING THE WRIT

I. The decision of the Court of Appeals is in Conflict with a Decision of the United States District Court for the Northern District of Texas; the District Court decision is currently on appeal by the United States to the United States Court of Appeals for the Fifth Circuit, raising the likelihood that there will be a conflict between the Seventh and Fifth Circuits on this issue.

The issue presented in this case has been the subject of only one other judicial decision, namely *Centennial Savings Bank FSB v. United States*, 682 F.Supp. 1389 (D.C.N.D. Tex. 1988). In *Centennial* (which was decided after the Tax Court decision in the instant case but prior to the decision of the Court of Appeals herein), Acting Chief Judge Sanders held that the Tax Court's conclusion in the instant case was in error and that the forfeitures *did* qualify for I.R.C. §§108 and 1017 treatment. He rejected the Commissioner's argument that the forfeitures were merely a means by which the depositor satisfied its "separate and distinct" obligation to the financial institution, stating that:

> "The early withdrawal penalty provision in the certificate of deposit agreement does not constitute a separate contract, and the fact that the penalty was predetermined does not transform it into one. The Court finds that no *separate* payment was made, whether it was fixed or based on market rates. Moreover, contrary to the Tax Court's holding in *Colonial Savings*, the "purity" of the cancellation of indebtedness represented by the forfeiture income in this case is not at issue, because the penalty provision is an integral part of the contract, not merely an ancillary "method" or "medium" by which the debt was reduced. Thus, the penalty income was liquidated debt, not liquidated damages."

682 F.Supp. at 1402. Obviously, Petitioners believe that Judge Sanders' analysis is correct and that the conclusions reached by the Tax Court and the Court of Appeals in the instant case were erroneous. More to the point for purposes of this Petition, however, is that the Commissioner is appealing the *Centennial* case to the Court of Appeals for the Fifth Circuit. If, therefore, the Fifth Circuit were to affirm Judge Sanders' decision on this point, an irreconcilable conflict would exist between the Courts of Appeals for the Seventh and Fifth Circuits, which can only be resolved this Court.

It is respectfully requested that this Court delay taking any action with respect to this Petition until the Fifth Circuit has decided the *Centennial* case. Then, if the District Court's decision on this issue in *Centennial* is affirmed, this Court can intervene to resolve the conflict while, if the District Court's decision is reversed, this Court can then decide whether there are other reasons to grant the writ herein requested. If, instead, this Court were to deny this Petition and if the Fifth Circuit were then to affirm the District Court's decision in *Centennial*, the savings institutions located in the Seventh Circuit could be

placed at a significant competitive disadvantage as compared with institutions located elsewhere. This result would follow because, if the Petition herein were to be denied, the Commissioner would undoubtedly take prompt action to collect the tax deficiencies owed by institutions located in the Seventh Circuit in connection with this issue[8] and they would have no method of recovering those taxes even if the Supreme Court were eventually to resolve the issue against the Commissioner.

II. The reasoning underlying the decision of the Court of Appeals is also in conflict with decisions of this Court and other federal courts.

As noted above, the *Centennial* case is the only other judicial decision to focus on the precise issue presented in this case, namely the applicability of I.R.C. §§108 and 1017 to forfeitures required on account of early withdrawals from financial institutions. More broadly, however, the analysis used by the Court of Appeals herein in deciding what is and what is not income from the forgiveness of indebtedness conflicts with a long line of judicial authorities starting with a landmark 1931 decision of this Court.

The first case which definitively established the rule that forgiveness of indebtedness income results in income to the debtor was *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), in which a taxpayer that had issued bonds for $12,126,800 redeemed the same bonds in a subsequent year for $137,521.30 less than their face amount. The question before the Supreme Court was whether the $137,521.30 differential constituted taxable income to the issuer and the Court answered this question affirmatively. *Kirby Lumber* is universally recognized as the "classic" debt discharge case and the case which ultimately prompted Congress to

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[8] The magnitude of the problem is illustrated by the size of the additional income at issue in this case ($600,744 in one year), despite Colonial's relatively small size.

enact the predecessor to I.R.C. §§108 and 1017 and it can fairly be concluded that, if a transaction would be covered by *Kirby Lumber*, it is eligible for the deferral benefits provided by I.R.C. §§108 and 1017. *See generally* Bittker & Thompson, Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co., 66 *Cal. L. Rev.* 1159 (1978).

One of the limitations on *Kirby Lumber* (and I.R.C. §§108 and 1017) that has developed over the years is that, if the debt discharge is merely a method by which the creditor satisfies its own "separate and distinct" obligation to the debtor, the income realized by the debtor is not considered "true" discharge of indebtedness income and is ineligible for the deferral benefits of I.R.C. §§108 and 1017. These types of transactions have been labeled "spurious" debt discharges. For example, in the above-cited article, Bittker and Thompson postulate an employer who lends $50 to an employee with the understanding that the debt will be deducted from the employee's check on payday. On payday, the debt owed by the employee to the employer is formally cancelled, although no money passes from the employee to the employer, and this appears as if the employee's debt has been discharged. In fact, however, the employee's debt has actually been paid in full on payday, and there is no discharge of debt, since the employee has "paid" his debt in full by rendering his services and relieving the employer of his obligation to pay $50 in compensation to the employee. Therefore, the income recognized by the employee on payday is not income arising by reason of the discharge of indebtedness under *Kirby Lumber* but is rather compensation income, which is ineligible for deferral under I.R.C. §§108 and 1017. And *see Spartan Petroleum Co. v. United States*, 437 F.Supp. 733 (D.S.C 1977) and *OKC Corp. & Subsidiaries v. Commissioner*, 82 T.C. 638 (1984), holding similarly in situations in which the creditor owed a separate amount to the debtor which would have had to be satisfied in some other manner if the debt discharge had not occurred.

In the instant case, the Court of Appeals applied this exception, concluding (i) that the depositor, at the time of the debt discharge, owed a "separate and distinct" obligation to the financial institution and (ii) that the partial discharge of the debt owed by the institution to the depositor was merely the medium by which the depositor satisfied this other obligation. Therefore, the Court concluded, this was not a "true" debt discharge and I.R.C. §§108 and 1017 were unavailable. If there was such a "separate and distinct" obligation owed by the depositor, the decision of the Court of Appeals might be supportable. In fact, however, as correctly concluded by Acting Chief Judge Sanders in *Centennial*, there was no such obligation and the Court of Appeals' reasoning in reaching a contrary conclusion would essentially eliminate the concept of income by reason of the discharge of indebtedness under *Kirby Lumber*, as developed by this and other Courts. The Court of Appeals thus began its analysis of this point with the curious statement that, in an early withdrawal transaction (as contrasted with the "typical section 108 transaction"), "the debtor receives a payment from the creditor." Appendix, p. A-12. Presumably, the Court was referring to the "penalty" received by the debtor/institution from the creditor/depositor but, of course, there was no more "payment" made by the depositor here than was made by the bondholders in *Kirby Lumber*. The Court of Appeals then continued as follows:

> "Moreover, that payment is to compensate the bank-debtor for the harm done by the depositor's change in position. It is a form of liquidated damages for the added expense that the bank must suffer in an effort to procure the funds that have been lost. In this regard, it plays a role in the debtor-creditor relationship not unlike that played by other penalties enacted when one party to a transaction changes course and, in so doing, upsets the settled expectations of the other party. While the income produced by the penalty arose

> out of a debtor-creditor relationship, it did not arise 'by reason of the discharge of indebtedness'."

Appendix at pp. A-11, 12. The problem with this analysis, however, is that the same conclusion would follow in *Kirby Lumber*, since the bond holders there agreed to pay a "penalty" to the taxpayer (in the form of accepting a reduced payment on their debt) in order to recover their debt prior to its maturity. Indeed, the only distinctions between the transaction at issue in this case and the "classic" debt discharge transaction in *Kirby Lumber* is that (i) in the instant case, the transaction was initiated by the creditors on account of rising interest rates, while the redemption in *Kirby Lumber* was initiated by the debtor, possibly because of falling rates and (ii) in the instant case, the amount of the "penalty" was determined in advance in the contact between the parties while, in *Kirby Lumber*, it was determined at the time of the redemption. There was, however, no indication in *Kirby Lumber* (or in the legislative history of I.R.C. §§108 and 1017) to indicate that these factors have any relevance to the question under discussion. Moreover, in at least one case, decided by the United States Court of Appeals for the Second Circuit, it was held that I.R.C. §§108 and 1017 would apply under these circumstances. *See Columbia Gas System, Inc. v. United States*, 473 F.2d 1244 (2d Cir. 1973).[9]

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[9] In *Columbia Gas*, the taxpayer had issued convertible debentures which provided by their terms that, in the event of a conversion by the debenture holder, the holder would forfeit any interest which was accrued but unpaid through the date of conversion. The Commissioner claimed that the accrued but unpaid interest on the converted debentures constituted income from the discharge of indebtedness and the Court of Appeals agreed. This raised the question of whether such income could be deferred under I.R.C. §§108 and 1017 and the Court held it could not be deferred, but *only* because a timely basis election had not been filed. Except for the untimely election, the relevant facts in

(Footnote continued on the following page)

In summary, by finding that the debt discharges that occurred in the instant case were somehow not "true" discharges, the Court of Appeals here departed from the approach which was adopted by this Court in *Kirby Lumber* and which has been followed uniformly since that case by other federal courts.

III. The decision of the Court of Appeals departed from the accepted and usual course of judicial proceedings by (a) grossly misinterpreting a Revenue Ruling issued by the IRS (without having had the benefit of any analysis of that Ruling by the parties) and (b) then relying on Congress' failure to act in response to that Ruling as an indication of a legislative acceptance of a position not even addressed therein.

There is one final reason why this writ should be granted, which is that the Court of Appeals so far departed from the accepted and usual course of judicial proceedings as to call for an exercise by this Court of its power of supervision. This departure occurred when the Court of Appeals relied in reaching its conclusion on an argument not even discussed by the parties in their briefs or oral arguments, which is that Congress' failure to clarify I.R.C. §108 in the years following Rev. Rul. 73-511, 1973-2 C.B. 402 indicated a Congressional acceptance of the Commissioner's argument in this case.

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9 *(continued)*

Columbia Gas are identical to those in the instant case, in that a creditor (that is, the debenture holder) elected to forfeit a portion of the amount owed to it in order to redeem (or, in *Columbia Gas*, in order to convert) its debt instrument prematurely; in *Columbia Gas*, the interest so forfeited was held to constitute income realized from the discharge of indebtedness under I.R.C. §108 and a similar conclusion should have been reached in the instant case. Moreover, as is noted in the text, it is significant that, as in the instant case, the debt discharges in *Columbia Gas* were initiated by the creditors; furthermore, as in the instant case, the amount of the discharge was, in effect, set forth in the underlying debt instrument.

There are several objectionable aspects to this conclusion.

First, as noted, Rev. Rul. 73-511 was barely addressed in the Tax Court's opinion and in the briefs filed with the Court of Appeals or in oral argument. Presumably as a consequence of this absence of analysis, the Court seriously misinterpreted the Ruling. Rev. Rul. 73-511, thus, dealt with two issues, namely (i) how a financial institution should treat interest and forfeitures on prematurely withdrawn time accounts for purposes of filing information returns (Form 1099-INT) and (ii) how the depositor should report the interest and forfeiture on the depositor's income tax return for the year of withdrawal. The Service's answer to the first question was that the gross amount of the interest credited or paid through the date of withdrawal must be reported on the information return, with no offset for the amount of the forfeiture. The Service's answer to the second question was that the depositor would have to report in income the gross amount of the interest paid or credited through the date of withdrawal and claim any forfeiture as a separate loss under I.R.C. §165(a). Both answers were based on the reasoning that the interest, as and when credited to the account, was available for withdrawal by the depositor at any time without limitation or restriction; therefore, under general principles of tax law, all of such interest was already "received" (constructively) by the depositor prior to the premature withdrawal of the account, requiring all of such interest to be reported as income. It can be seen, therefore, that Rev. Rul 73-511 has little relevance to the instant appeal. For one thing, Rev. Rul. 73-511 is concerned only with the interest portion of a withdrawal transaction and its conclusion is based on the depositor's constructive receipt of the interest. In savings accounts of the type under discussion in Rev. Rul. 73-511 (and in the instant case), the depositor has the unfettered right to withdraw all of the interest credited to the account at any time, but he does not have the right to withdraw the

principal; therefore, as the Court of Appeals failed to recognize, the Ruling does not stand for the proposition that the depositor actually recovers 100 percent of his principal balance and, in fact, it leads to a contrary conclusion. Moreover, it can be seen that the Ruling is concerned only with the treatment of the depositor, which has no statutory nor logical relationship to the handling of the transaction by the financial institution. Accordingly, contrary to the Court's conclusion, Rev. Rul. 73-511 could not have alerted Congress to the position being asserted by the Commissioner in the instant case with respect to I.R.C. §108 and the failure of Congress to address that position cannot have any bearing on the meaning of that Section.

Second, even if Rev. Rul. 73-511 meant what the Court of Appeals erroneously thought it meant, the Court would have been wrong in relying so heavily on Congress' failure to amend I.R.C. §108 in response to that Ruling. *See Zuber v. Allen*, 396 U.S. 314 (1969), in which this Court noted properly that "[l]egislative silence is a poor beacon to follow in discerning the proper statutory route." Surely, it cannot reasonably be concluded in this case that the Congressional "silence" as to the impact of Rev. Rul. 73-511 on financial institutions under I.R.C. §108 was so significant as to establish the meaning of that Section. And, of course, this is especially true in view of the fact that Rev. Rul. 73-511 did not even relate to that Section.

The point here being made is not just that the Court of Appeals was "wrong." Rather, it is submitted that the Court reached its conclusion on the basis of reasoning which grossly violates generally accepted principles of statutory interpretation. For that reason alone, granting of this writ is justified.

CONCLUSION

For all the reasons stated herein, it is respectfully requested that this Court (1) delay taking any action with respect to this Petition for Certiorari until the Fifth Circuit Court of Appeals has decided the *Centennial* case, and (2) in any event, to grant this Petition.

Respectfully submitted,

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APPENDIX

In the
United States Court of Appeals
For the Seventh Circuit

Nos. 87-1012 & 87-1633

COLONIAL SAVINGS ASSOCIATION AND SUBSIDIARIES,

Petitioners-Appellants,
Cross-Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee,
Cross-Appellant.

Nos. 87-1499 & 87-1500

FRONTIER SAVINGS AND LOAN ASSOCIATION,

Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Appeals from the United States Tax Court
No. 25477-82—Joel Gerber, *Judge.*
Nos. 16209-81, 24559-83—Stephen J. Swift, *Judge.*

ARGUED DECEMBER 3, 1987—DECIDED AUGUST 10, 1988

Before BAUER, *Chief Judge*, RIPPLE, *Circuit Judge*, and WILL, *Senior District Judge.**

RIPPLE, *Circuit Judge*. These appeals present two separate questions of tax law, and require us to review two different decisions of the United States Tax Court.[1] The first issue is whether early withdrawal penalties received by banking institutions from depositors constitute discharge of indebtedness income to the institutions under section 108 of the Internal Revenue Code of 1954 (the Code). The second issue is whether shareholders of the Chicago Federal Home Loan Bank recognized income upon the receipt of stock dividends in 1978 and 1979, under section 305 of the Code, when none of the shareholders had a legal right to receive cash in lieu of stock, but the Chicago Federal Home Loan Bank had never refused any of its shareholders' redemption requests after a stock dividend.

In an opinion filed November 26, 1985, the Tax Court ruled that early withdrawal penalties constitute regular income to banking institutions and not discharge of indebtedness income. *Colonial Sav. Ass'n v. Commissioner*, 85 T.C. 855 (1985). In an opinion filed September 24, 1986, the Tax Court ruled that no shareholder of the Chicago Federal Home Loan Bank had an election to receive cash in lieu of stock, and that therefore the shareholders did not realize income upon the receipt of stock dividends. *Frontier Sav. & Loan Ass'n v. Commissioner*, 87 T.C. 665 (1986). We shall analyze each issue separately. For the reasons set forth in the following opinion, we affirm both decisions of the Tax Court.

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* The Honorable Hubert L. Will, Senior District Judge for the Northern District of Illinois, sitting by designation.

[1] These cases were consolidated because one of the questions—the appropriate tax treatment of stock dividends of the Chicago Federal Home Loan Bank—is presented by both taxpayers.

I

Early Withdrawal Penalties

A. *Facts*

The facts of this case have been stipulated. The appellant is Colonial Savings Association (Colonial), a Wisconsin savings and loan association. Colonial filed a timely corporation income tax return for its taxable year ended June 30, 1980, with the Internal Revenue Service (the IRS). On July 29, 1982, the IRS issued Colonial a notice of deficiency. On October 19, 1982, Colonial filed a timely petition with the United States Tax Court. One of the subjects of dispute between Colonial and the IRS was Colonial's treatment of early withdrawal penalties that it had received from depositors who prematurely had withdrawn amounts from their accounts. The IRS contended that these penalties were regular income to Colonial. Colonial submitted that these penalties were discharge of indebtedness income, and therefore were subject to favorable tax treatment as existed under section 108 of the Code at that time.[2]

During its taxable year ended June 30, 1980, Colonial had various types of savings accounts outstanding, differing from each other in term, interest rate and other particulars. Interest on all of the accounts in question was computed on a daily basis and added each day to the depositors' accounts. The parties agree that a bona fide indebtedness existed between Colonial and its depositors on any given day equal to the amount of principal and accrued interest on each account. Although Colonial used the cash method of accounting for tax purposes, Colonial deducted under section 591 of the Code the year's aggregate of interest that had been credited to its depositors' accounts.

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[2] The current version of section 108, as amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, Sec. 822(a), provides that favorable tax treatment is not available from the discharge of indebtedness unless the discharge occurs in a bankruptcy case or when the taxpayer is insolvent.

When a depositor withdrew the principal balance in any of the accounts in question prior to the account's maturity date, the depositor was required by federal regulation to pay a penalty to Colonial. *See* 12 C.F.R. § 526.7(a) (1979) & 12 C.F.R. § 526.7(a) (1980). The amount of this penalty was prescribed by the same federal regulations.[3] Under terms of the account between the depositor and Colonial, the penalty was paid by reducing the amount that Colonial gave the depositor upon withdrawal.

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[3] For the relevant tax year, the early withdrawal penalty regulations provided two different possible penalties. For accounts opened before July 1, 1979, the pertinent penalty was as follows:

> For any certificate account issued after October 31, 1973 . . ., a member shall impose the following conditions on any withdrawal before the end of the term or qualifying period: (1) The account holder shall receive interest or dividends from the date of issuance of the account on the amount withdrawn at a rate not exceeding the rate being paid on regular accounts; and (2) the account holder shall pay a penalty of at least (i) the interest or dividends at such rate for 90 days (3 months) on the amount withdrawn or (ii) all interest or dividends at such rate (since issuance or renewal of the certificate account) on the amount withdrawn.

12 C.F.R. § 526.7(a) (1979). For accounts opened after June 30, 1979, the relevant penalty was as follows:

> For any certificate account issued, extended, or renewed after June 30, 1979, a member shall impose (except as paragraph (c) of this section provides) the following conditions on any withdrawal before the end of the term or qualifying period:
>
> (1) If the term or qualifying period is one year or less, the account owner shall pay a penalty on the amount withdrawn of at least 90 days (3 months) earnings on the account. If the amount withdrawn has remained on deposit for 3 months or less, all earnings shall be forfeited.
>
> (2) If the term or qualifying period is more than one year, the account owner shall pay a penalty on the amount withdrawn of at least 180 days (6 months) earnings on the account. If the amount withdrawn has remained on deposit for 6 months or less, all earnings shall be forfeited.

12 C.F.R. § 526.7(a) (1980).

During the tax year at issue, Colonial received $600,744.88 in early withdrawal penalties. The parties agree that at least 90 percent of the early withdrawals were motivated by rapidly increasing interest rates. That is, because of an increase in interest rates, depositors determined that they were better off paying the penalty rather than leaving their money in an account that paid below-market interest rates.

B. *The Tax Court Opinion*

The Tax Court determined that early withdrawal penalties were regular income and not discharge of indebtedness income. The court acknowledged that a debtor does not have income from the discharge of indebtedness "if the debt forgiveness is simply the method by which a creditor makes a payment to a debtor." *Colonial Sav. Ass'n v. Commissioner*, 85 T.C. 855, 866 (1985). The court then said that the facts and circumstances of early withdrawal penalties did "not give rise to cancellation or discharge of the debt." *Id.* Rather, the court believed that the "penalty or forfeiture was an obligation of the depositor, which petitioner and depositor agreed, in advance, could be satisfied from interest credited or principal deposited in the account." *Id.* at 867.

The court also noted that Colonial had no need for relief from discharge of indebtedness income. The court said that Colonial had had the use of depositors' funds, and had received a tax deduction for interest credited to the depositors' account, even though no interest actually had been paid. Thus, there was no hardship to Colonial from having to recognize income immediately.

C. *Contentions of the Parties*

Colonial argues that early withdrawal penalties represent a reduction in the debt that Colonial owes the depositor. Colonial points out that both parties agree that a debtor-creditor relationship exists between Colonial and the depositor, and that savings accounts represent a bona

fide indebtedness. Thus, when a depositor withdraws his account prematurely, the withdrawal penalty represents a reduction in the amount Colonial owes the depositor. Colonial therefore submits that the early withdrawal penalty is not a separate and distinct obligation from the indebtedness, but is simply a reduction in the amount that the depositor owes Colonial.

The IRS submits that the early withdrawal penalty represents a separate obligation from the depositor to Colonial. The IRS argues that, in effect, a depositor receives from Colonial the full amount of his account, but then pays back to Colonial a portion of that amount as a penalty. According to this theory, the discharge of indebtedness is merely the medium of payment of the penalty, and the early withdrawal penalty is regular income to Colonial.

D. *Discussion*

In essence, the parties ask that we choose between two characterizations of withdrawal penalty income. The taxpayer submits that such income is income from the discharge of indebtedness; the Commissioner submits that it is regular income.[4] Determining which of these characterizations is most appropriate involves a two-step inquiry. First, we must examine the statutory scheme. While it hardly provides us with a definitive answer, this legislative framework is indispensible because our task is to give effect to the congressional intent, however obscure its expression. Second, we must analyze this particular banking transaction in light of the statutory framework and decide upon a characterization that seems most in harmony with the congressional intent.

[4] The issue presented here has been addressed by two other courts—the Tax Court, ruling in this case, and a single district court, *Centennial Savings Bank FSB v. United States*, No. CA 3 86-1396-H (N.D. Tex. Jan. 22, 1988). The court in *Centennial* ruled for the taxpayer, essentially adopting the argument presented by Colonial here. For the reasons set forth in this opinion, we respectfully disagree with the reasoning of the district court.

1. The Statutory Framework

Section 61(a) of the Code provides that gross income means all income, from whatever source derived, including "[i]ncome from discharge of indebtedness." 26 U.S.C. § 61(a)(12). As a general rule, a taxpayer may realize income from the discharge of indebtedness when the taxpayer's debt is forgiven, cancelled, or otherwise discharged for less than the face amount of the debt. *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). This general proposition is subject to several exceptions. For the tax year in question here, section 108 of the Code provided in pertinent part:

> No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—
>
> (1) the indebtedness was incurred or assumed—
>
> (A) by a corporation, or
>
> (B) by an individual in connection with property used in his trade or business . . . .

26 U.S.C. § 108 (1976). If a taxpayer qualified for section 108 treatment, it was necessary that it file an election agreeing to make certain negative adjustments in the tax basis of its assets. Colonial filed such an election here.

The legislative history of section 108 evidences that it is the product of a congressional concern that a corporation receiving a forgiveness of indebtedness ought not be required to pay an immediate tax on the paper increase in its value; the transaction did not produce assets that can be used in paying the tax. Congress apparently believed that immediate taxation of debt discharges would discourage taxpayers from reducing their indebtedness. H.R. Rep. No. 855, 76th Cong., 1st Sess. 5, *reprinted in* 1939-2 C.B. 504, 507; S. Rep. No. 1631, 77th Cong., 2d Sess. 46, 78, *reprinted in* 1942-2 C.B. 504, 542; *see also* 97 Cong. Rec. 3796 (1951) (statement of Rep. Camp).

Rather, under section 108, the tax liability may be handled through an adjustment in the basis of the corporation's existing assets. While section 108 has undergone a textual metamorphosis throughout its statutory life,[5] we discern no basic shift in its purpose. The case law interpreting the section, while sparse, is consistent with this legislative intent. For instance, in *Reliable Incubator & Brooder Co. v. Commissioner*, 6 T.C. 919, 926-27 (1946), the taxpayer-debtor had an obligation of $6,700 on which he was obliged to make $50 monthly payments. His creditor was in need of funds. Therefore, the parties agreed to reduce the outstanding debt by $1,200 in exchange for an advance payment of $600. While factors not relevant here precluded relief for the taxpayer,[6] the tax court did determine that there was $600 of income from discharge of indebtedness to the taxpayer-debtor. Similarly, in *Columbia Gas System v. United States*, 473 F.2d 1244 (2d Cir. 1973), and *San Marcos Hotel Co. v. Commissioner*, 11 T.C.M. 388 (1952), *aff'd*, 205 F.2d 641 (9th Cir. 1953), discharges of indebtedness occurred when creditors accepted less than full value for the amounts they were owed in return for the benefit of early payment.

In each of the foregoing cases, the literal mandate of section 108 was followed. The taxpayer-debtor's income

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[5] Congress codified a predecessor to section 108 in the Internal Revenue Code of 1939. Section 22(b)(9) of that Code provided that a corporation could exclude the amount of a discharge of indebtedness from its gross income if the corporation was in an "unsound financial condition." In 1942, Congress removed the requirement that the corporation be in an "unsound financial condition." Revenue Act of 1942, ch. 619, 56 Stat. 798, § 114(a). Congress made several other changes to section 108 in 1954 and in 1980, none of which are material here. In 1986, Congress came full circle and inserted a requirement that the discharge of indebtedness occur in a bankruptcy case or when the taxpayer is insolvent. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, § 822(a).

[6] The taxpayer was not eligible for favorable tax treatment because he was not in unsound financial condition, and because he had not filed an election to adjust the basis of his assets.

was received "*by reason of the discharge* (in whole or in part) of indebtedness of the taxpayer." 26 U.S.C. § 108 (emphasis supplied). By contrast, when the discharge of indebtedness is a mere medium for the payment of a separate obligation between two parties, section 108 does not apply. If this were not the rule, taxpayers often could evade the recognition of ordinary income by structuring the receipt of income as a discharge of indebtedness. For instance, in an often-used example, an employee who owes a debt to his employer could avoid the recognition of income by merely asking his employer to withhold his wages as payment of the indebtedness. *See generally* Bittker & Thompson, Income From the Discharge of Indebtedness: The Progeny of *United States v. Kirby Lumber Co.*, 66 *Cal. L. Rev.* 1159, 1174 (1978). In *Spartan Petroleum Co. v. United States*, 437 F. Supp. 733 (D.S.C. 1977), a gasoline distributor was indebted to its franchisor Atlantic Richfield Company (ARCO). ARCO sought to cancel its franchise agreement with the debtor. In order to achieve this result, ARCO agreed to pay more than a million dollars to the debtor and forgive the debt. The Tax Court correctly concluded that this cancellation of indebtedness was not a section 108 discharge because the forgiveness of the indebtedness was a payment to the distributor in return for cancelling the franchise agreements. Similarly, in *OKC Corp. v. Commissioner*, 82 T.C. 638 (1984), an oil company agreed to forgive indebtedness of the taxpayer in return for the taxpayer's agreement to cancel an output contract. In these cases, unlike those discussed earlier, the taxpayer-debtor received income in payment of a separate obligation, not "by reason of the discharge . . . of indebtedness of the taxpayer." 26 U.S.C. § 108.

2. Application to Early Withdrawal Penalties

We begin by placing our inquiry in a procedural framework. Colonial, relying on section 108, seeks to exempt income from current taxation. Therefore, Colonial has the burden of establishing that it qualifies for discharge of indebtedness treatment. *Templeton v. Commissioner*, 719

F.2d 1408, 1411 (7th Cir. 1983); *Hintz v. Commissioner*, 712 F.2d 281, 284 (7th Cir. 1983). The burden is upon the taxpayer because exemptions and deductions from income are extensions of legislative grace; deductions are not matters of right. *Templeton*, 719 F.2d at 1411. With respect to a taxpayer's qualification for a deduction, it is presumed that the determinations of the Commissioner are correct. *Id.* A taxpayer is entitled to a deduction only if there is clear provision for the favorable tax treatment. *Id.*

In attempting to meet this burden, Colonial states its position succinctly:

> An early withdrawal forfeiture (whether or not designated a "penalty") is nothing more than an agreed-upon reduction in the financial institution's obligation to repay its entire debt and it would not even come into existence except for such repayment.

Colonial's Br. at 21. On the other hand, the Commissioner characterizes the facts differently. In his view, "Colonial did not have income 'by reason of the discharge' of indebtedness; it had income 'by reason of' receiving a penalty." Commissioner's Br. at 29.

In assessing the validity of these competing characterizations, we do not believe that the technical mechanics of the transaction ought to control the tax consequences. Rather, we must focus on the essential nature of the transaction. *See Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 174 (1926). Therefore, we must inquire into the nature of the "penalty" and determine whether it can be characterized properly as the sort of debt forgiveness that falls within the ambit of section 108. The fact that Colonial offset the amount of the penalty the depositor owed Colonial against the amount of principal and accrued interest is hardly controlling.

Even when we put to one side the mechanics of the transaction, we must admit that there is an initial appeal to Colonial's argument that the penalty is debt forgiveness. After all, whether the penalty is paid out of the

funds in the bank's custody or by the depositor's funds from other sources, the effect of the penalty is to ensure that Colonial's net obligation to its depositor is far less than it otherwise would have been.

On the other hand, there are several significant factors that militate against such a characterization. The penalty, as imposed by federal banking regulations, arises only at the time of the depositor's demand for withdrawal of his funds prior to the agreed term. It is a fee that the bank must impose on its depositor as consideration for altering the earlier contractual commitment of the funds for a longer period. The penalty serves to recognize that such changes in course, by those whom the Bank regarded as long-term depositors, involve significant instability and therefore significant costs for banks. The regulations also impose these penalties to ensure the systemic health of the nation's banking institutions by allowing those institutions to more "effectively . . . manage their liabilities." 45 Fed. Reg. 37,802 (1980).

At the very least, the transaction before us cannot be described as a typical section 108 transaction. As the cases demonstrate, in the usual section 108 transaction, there is the direct forgiveness of a debt, or a portion of a debt, that adds value to the worth of the debtor's business—although it does not add cash. Therefore, in those circumstances, it makes sense to reflect that enhanced value to the enterprise through an adjustment of the corporation's assets. Here, by contrast, the debtor receives a payment from the creditor. Moreover, that payment is to compensate the bank-debtor for the harm done by the depositor's change in position. It is a form of liquidated damages for the added expense that the bank must suffer in an effort to procure the funds that have been lost. In this regard, it plays a role in the debtor-creditor relationship not unlike that played by other "penalties" enacted when one party to a transaction changes course and, in so doing, upsets the settled expectations of the other party. While the income produced by the penalty arose out of a debtor-creditor relationship, it did not arise "by reason of the

discharge of indebtedness." Rather, it arose by reason of the creditor's alteration of the parties' contract and the consequential expenses of the bank/debtor.

We believe that the penalty involved here is sufficiently different from the usual circumstance governed by section 108 that Congress can be expected to have addressed specifically any special tax consequences surrounding its use. Congress clearly is aware of the tax problems caused by these financial arrangements. While it has chosen to address certain aspects of those tax consequences, it has chosen not to address this one. Since at least 1973 Congress has been on notice that the IRS views the early withdrawal penalty as a separate obligation rather than as a part of the underlying deposit/debt. In that year, the IRS issued Revenue Ruling 73-511, 1973-2 C.B. 402, in which the IRS required financial institutions to report on information returns the full amount of interest credited to depositors' accounts without reduction for any early withdrawal penalties that might have been incurred during the taxable year. This ruling was based on the rationale that early withdrawal penalties were considered separate obligations of the depositor to the bank. As a result of this ruling, it has been settled law since 1973 that taxpayers who have paid early withdrawal penalties may not merely reduce their interest income by the amount of the penalty. Rather, taxpayers must recognize the full amount of any interest income they have earned, and then they must claim early withdrawal penalties as a separate adjustment to their gross income. 26 U.S.C. § 62(a)(9).

Congress was immediately aware of Revenue Ruling 73-511 and took action to soften its impact for certain taxpayers. Congress enacted Pub. L. No. 93-483, §6(a), 88 Stat. 1458, (codified as amended at 26 U.S.C. § 62(a)(9)), one year after the ruling, which allowed all taxpayers, not just those who itemize deductions, to deduct early withdrawal penalties as an adjustment to gross income. However, nothing in this legislation or in its legislative history expresses disapproval of the revenue ruling's conclusion that interest income and early withdrawal penalties

are separate and distinct obligations, and that interest income and penalties cannot be set off for income tax purposes. In our view, this congressional response to Revenue Ruling 73-511 demonstrates that Congress is fully aware of the IRS's characterization of early withdrawal penalties, and that Congress does not disapprove. In such a circumstance, we cannot say that the IRS's position contravenes congressional intentions.

For the foregoing reasons, we conclude that early withdrawal penalties represent separate obligations from depositors to Colonial, and that therefore early withdrawal penalties are not income by reason of the discharge of indebtedness as that term is used in section 108 of the Code. Colonial has not met its burden of establishing that the IRS has erroneously determined that such payments constitute ordinary income.

II

Federal Home Loan Bank Dividends

A. *Facts*

In these appeals, Nos. 87-1633, 87-1499, and 87-1500, we must determine whether banking institutions received income upon receipt of stock dividends in 1979 and 1980 from the Federal Home Loan Bank of Chicago (the Chicago Bank). The relevant facts at issue in these appeals were described in detail by the Tax Court. We borrow heavily from its rendition.

Petitioner, Frontier Savings Association (Frontier),[7] is a Wisconsin savings and loan association. Frontier has been a member and stockholder of the Chicago Bank at all times since the organization of the Chicago Bank. The Chicago Bank is one of eleven district banks established

[7] As noted earlier, this issue is also present in Colonial's appeal. For the sake of clarity, however, we shall refer only to Frontier in our discussion.

pursuant to the Federal Home Loan Bank Act, 12 U.S.C. § 1421 *et seq.* The district banks initially were capitalized with stock subscriptions from member institutions and the United States Treasury. District banks operate under the supervision of the Federal Home Loan Bank Board (the Bank Board), an administrative agency in the executive branch of the federal government. 12 U.S.C. § 1437(b). The district banks are subject to extensive managerial supervision by the Bank Board. Among other responsibilities, the Bank Board appoints six of each bank's fourteen directors, 12 U.S.C. § 1427(a), designates the bank's chairman and vice chairman, 12 U.S.C. § 1427(g), and has the power to suspend or remove the bank's directors, officers, employees, and agents, 12 U.S.C. § 1437(a).

The Federal Home Loan Bank system was designed primarily as a reserve credit facility for savings and loan associations and other home mortgage credit institutions. Savings and loan associations (such as Frontier) and mutual savings banks that are members or stockholders in the district banks are required by federal law to maintain a certain capital stock ownership in the respective district banks of which they are members. The stock ownership requirements are determined at the end of each calendar year and are calculated with reference to each member bank's net home mortgage loans outstanding and total borrowings of each member from the district bank.

Each member bank generally must maintain a capital stock ownership interest in the district bank in an amount equal to at least one percent of the total outstanding balance of its home mortgage loans and at least equal to a certain percentage of outstanding borrowings of the member bank from the district bank, as of December 31 of each year.[8] Each share of stock in the district banks is

[8] For tax year 1978, which is at issue here, member banks had to hold stock equal to at least one-twelfth of their outstanding borrowings from the district bank. For tax year 1979, which also is at issue here, this requirement was decreased to one-twentieth of their outstanding borrowings. *See* 12 U.S.C. § 1426(c)(2).

valued by statute at its $100 par value. *See* 12 U.S.C. § 1426(b), (c). Based upon the above year-end calculations, member banks that are required to purchase additional stock of district banks must do so by January 31 of the following year. Member banks that own stock in district banks in excess of the required number of shares may request that excess shares be redeemed by the district banks. By statute, district banks are authorized to redeem excess shares, within the discretion of the district bank. 12 U.S.C. § 1426(c)(1).

The policy of the Chicago Bank with respect to the redemption of excess shares is reflected in the minutes of a June 18, 1979 meeting of the Chicago Bank's board of directors, as follows:

> BE IT RESOLVED, that the President of the Bank or any officer designated by him may from time to time increase or decrease the amount of stock of any member in accordance with Section 6 of the Federal Home Loan Bank Act [i.e., 12 U.S.C. §1426(c)] and the Regulations for the Federal Home Loan Bank System; provided, however, that in exercising the Bank's discretion whether or not to grant an application by a member to decrease its stock, the President or his designee shall be guided by all applicable statutory and regulatory provisions, all policies and standards adopted from time to time by this Board, including, but not limited to, the Bank's credit standards contained in the "Policies Governing Extension of Credit" as adopted by this Board and all relevant facts and circumstances.

However, the decision to redeem a member's stock is not entirely within the judgment of the district bank. Federal statute allows the Bank Board to prohibit a particular redemption. 12 U.S.C. § 1426(c).

As stockholders in district banks, member banks are entitled to receive dividends that are declared by district banks. Prior to December 29, 1978, dividends always had been paid by the Chicago Bank to its member banks in

cash. On that date, dividends were paid by the Chicago Bank to its member banks in the form of additional shares of common stock. On December 31, 1979, dividends were paid by the Chicago Bank to its member banks half in stock and half in cash.

December 29, 1978, Stock Dividend

At a meeting on November 20, 1978, the board of directors of the Chicago Bank adopted a resolution to pay a 6.58 percent dividend to its stockholders of record as of December 31, 1978. Subject to the approval of the Bank Board, the resolution stated that the dividend would be paid in the form of stock in the Chicago Bank. On December 22, 1978, the Director of the Office of District Banks, Federal Home Loan Bank Board, wrote a letter to the President of the Chicago Bank approving the stock dividend.

On December 22, 1978, the Chicago Bank mailed a bulletin to its member banks informing them that a 6.58 percent stock dividend would be paid. The explanation made in the bulletin for paying a stock dividend, rather than a cash dividend, was as follows:

> (1) Providing a stock rather than a cash dividend may enable your association to defer the payment of income taxes on the value of the stock dividend. You may wish to consult your tax adviser for the proper handling of a stock dividend.
>
> (2) A stock dividend can be applied toward satisfying the stock investment requirement for members that experienced a growth in assets during 1978 or that will be required to purchase additional stock due to increased borrowings from the Bank.

The bulletin also explained that most member banks would be required to increase their stock holdings in the Chicago Bank due to that year's general increase in outstanding home mortgage loans. On December 29, 1978, a total of 234,620 shares of common stock was distributed by the

Chicago Bank as a stock dividend to its 497 member banks. Frontier received 588 shares of common stock in the Chicago Bank (and cash representing fractional shares in the amount of $51.07) as its share of the 1978 stock dividend.

Enclosed with the December 22, 1978 bulletin mailed by the Chicago Bank to its member banks describing the 1978 stock dividend was a form entitled "Calculation of Bank Stock Requirement as of December 31, 1978." Using that form, each member bank could calculate the number of shares of stock it was required to own in the Chicago Bank as of December 31, 1978. If a member bank was required to purchase additional shares of stock, it could submit the form (reflecting the number of shares to be purchased) along with payment to the Chicago Bank. If the member bank held more shares than it legally was required to own, it could use the form to request the redemption of any excess shares. Although the Chicago Bank had no legal obligation to redeem excess shares, it had never declined a redemption request.

On January 16, 1979, Frontier completed the form calculating the number of shares of common stock in the Chicago Bank it was required to own. That calculation indicated that Frontier needed to purchase 678 additional shares of common stock in the Chicago Bank (after taking into account the shares received as part of the common stock dividend on December 29, 1978). During 1979, none of the shares of common stock in the Chicago Bank owned by Frontier were redeemed or otherwise transferred. However, 69 member banks requested that the Chicago Bank redeem at least some of their shares. The Chicago Bank honored all of these requests. Forty-five member banks redeemed at least as many shares as they had received in the stock dividend.

December 31, 1979 Cash and Stock Dividends

At a meeting on November 19, 1979, the board of directors of the Chicago Bank adopted a resolution, subject

to the approval of the Bank Board, to pay a 10 percent dividend to its stockholders of record as of December 31, 1979, half of which would be paid in cash and half of which would be paid in common stock. The Bank Board approved this dividend. On December 21, 1979, the Chicago Bank mailed a bulletin to its member banks informing them of the dividend. On December 31, 1979, the Chicago Bank distributed the 1979 dividends by (1) adding the appropriate number of whole shares of stock to the stock account of each member, and (2) adding to the demand account of each member the amount representing the cash portion of the dividend as well as the amount of cash representing fractional shares of stock distributed as part of the dividend. Frontier received 514 shares of Chicago Bank common stock and $51,567.87 in cash as its portion of the dividend.

The December 21, 1979 bulletin mailed to member banks concerning the 1979 dividends explained that "to help preserve the non-taxable characteristics of the stock dividend" a new procedure was being adopted for the purchase and disposition of excess shares. Instead of having member banks purchase additional shares of stock from the Chicago Bank and having the Chicago Bank redeem excess shares from member banks, the new procedure called for member banks who had excess shares they wished to dispose of to sell such excess shares to other member banks who wished to buy additional shares. Enclosed with the December 21, 1979 bulletin was a form entitled "Calculation of Bank Stock Requirement" as of December 31, 1979, and a separate form that could be used by the member banks to express their desire to sell excess shares of stock in the Chicago Bank to other member banks. Frontier calculated that it needed to purchase 520 additional shares of common stock in the Chicago Bank. Frontier therefore mailed a $52,000 check to the Chicago Bank and was credited with 520 shares of stock.

Exclusive of the December 31, 1979 stock dividends, 282 of the Chicago Bank's 497 member banks owned sufficient

shares of stock in the Chicago Bank to meet their stock ownership requirements on December 31, 1979. After receipt of their 1979 stock dividends from the Chicago Bank, 31 member banks sold some of their stock to other member banks and 10 bought additional stock from member banks. Sales of excess shares between member banks occurred only in January 1980. Excess shares that member banks wished to dispose of after January 1980 were redeemed by the Chicago Bank. Between February 1, 1980, and December 31, 1980, 64 member banks asked the Chicago Bank to redeem their excess shares. All of these requests were honored. Sixty of the 64 asked to have redeemed a number of shares that was equal to or exceeded the number of shares they received as their portion of the 1979 stock dividend. None of the shares of stock received by Frontier were redeemed in 1980. In January 1982, Frontier asked the Chicago Bank to redeem 3,584 shares. The request was honored.

Frontier did not report the 1978 and 1979 stock dividends as income on its tax returns for either 1978 or 1979. The IRS determined that the 1978 dividend was includible in Frontier's income in 1978 in the amount of $58,576.20, and that the 1979 dividend was includible in Frontier's income for 1979 in the amount of $51,230. Frontier then petitioned the Tax Court seeking review of the IRS's claimed deficiencies.

B. *The Tax Court Opinion*

Section 305(a) of the Code sets forth the general rule that stock dividends are customarily not includible in a shareholder's gross income. However, section 305(b)(1) of the Code provides that a stock dividend is taxable if the dividend is payable in either stock or property "at the election of any of the shareholders . . . ." 26 U.S.C. § 305(b)(1). The IRS argues that such an election was present here because the Chicago Bank had never refused a redemption request.

In a decision by Judge Swift,[9] the Tax Court concluded that the Chicago Bank was not required to redeem excess shares, but rather chose to do so at its discretion. *Frontier Sav. Ass'n v. Commissioner*, 87 T.C. 665 (1986).[10] Because the Chicago Bank retained this discretion, the court concluded that member banks "did not have the option or election to have the Chicago Bank redeem excess shares. . . ." *Id.* at 677. In response to the IRS's contention that the Chicago Bank had, in effect, abdicated its discretion, the Court said:

> Our careful examination of the record herein satisfies us that the manner in which stock dividends were paid and redeemed in 1978 and 1979 by the Chicago Bank was consistent with that grant of discretionary authority and did not vest in the member banks the unilateral right to elect or to require the Chicago Bank to redeem excess shares upon request.

Id. at 676-77.

The Tax Court also noted that, at the time stock dividends were declared and distributed in 1978 and 1979, member banks did not yet know whether they would be entitled to request a redemption. Referring to the date of distribution, the court said that "member banks could not know (other than through estimates and projections) whether they would be required to retain the stock dividends they received as part of their required investments in the district bank or whether the stock dividends would qualify as excess shares . . . ." *Id.* at 677.

In a concurring opinion, Judge Hamblen, joined by three other judges, joined in the majority's conclusion "based

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[9] Thirteen other Tax Court judges agreed with Judge Swift's opinion, including four judges who filed a brief concurring opinion. One judge dissented.

[10] The Tax Court has recently reached the same result as it reached here in a case involving stock dividends of the Federal Home Loan Bank of Des Moines. *Western Fed. Sav. & Loan Ass'n v. Commissioner*, 55 T.C.M. 372 (1988).

upon the limited factual circumstances involved." *Id.* at 679. He opined that an election might exist under section 305(b)(1) if the decision to redeem stock dividends "becomes a routine matter." *Id.*

C. *Contentions of the IRS*

The IRS emphasizes that the Chicago Bank has never declined a request to redeem excess shares. Because of that circumstance, the IRS submits that there is "no doubt that the shareholders for whom the dividend shares were excess shares had, as a practical matter, an election to redeem those shares for cash." Commissioner's Br. at 17. The IRS further submits that the analysis of the Tax Court is wrong because, under that analysis, a shareholder does not have an election to receive stock or property unless that shareholder has a legally binding right to demand redemption. According to the IRS, nothing in section 305 suggests that "its application should turn on the niceties of a shareholder's legal rights." *Id.* Rather, argues the IRS, the existence of an election ought to be premised on an evaluation of all the circumstances of a dividend. Under such a test, the IRS contends that, as a practical matter, an election existed here and the shareholders should be deemed to have received income according to the value of the stock dividends received.

D. *Discussion*

Section 305(a) of the Code establishes the general rule that stock dividends are not taxable to the recipient.[11] The rationale for this rule is that a pure "stock dividend

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[11] Section 305(a) provides:

> Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.

26 U.S.C. § 305(a).

is commonly thought of as a mere readjustment of the stockholder's interest, and not as income." S. Rep. No. 552, 91st Cong., 1st Sess. 150, *reprinted in* 1969-3 C.B. 423, 519. However, section 305(b) of the Code identifies several situations in which the receipt of a stock dividend will generate taxable income. The exception to the general rule relevant here is section 305(b)(1), which provides that a stock dividend is taxable "[i]f the distribution is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either—(A) in its stock, or (B) in property." 26 U.S.C. § 305(b)(1). The reason behind this exception to the general rule is that, when such an election exists, "the stockholder who receives a stock dividend is in the same position as if he received a taxable cash dividend and purchased additional stock with the proceeds. His interest in the corporation is increased relative to the interests of stockholders who took dividends in cash." S. Rep. No. 552, *supra*, *reprinted in* 1969-3 C.B. 423, 519.

The issue presented here is whether any of the shareholders of the Chicago Bank had an "election" to receive dividends in stock or cash when many shareholders of the Bank redeemed their stock dividend soon after it was distributed. We agree with the Tax Court that the federal statute governing stock redemptions by Federal Home Loan Banks is of substantial importance to a resolution of the precise question before us. That statute, 12 U.S.C. § 1426(c), provides that a Federal Home Loan Bank is not required to honor any redemption request. Rather, the statute notes that redemption requests shall only be granted within the discretion of the local bank, and further provides that the Bank Board may prohibit a redemption. The statute reads:

> If the bank finds that the investment of any member in stock is greater than that required under this subsection it may, unless prohibited by said Board [i.e., the Federal Home Loan Bank Board] or by the provisions of paragraph (2) of this subsection, in its discretion and upon application of such member retire

> the stock of such member in excess of the amount so required.

12 U.S.C. § 1426(c)(1). This statute has not always so limited the right of a member bank to redeem its stock, however. Prior to 1961, section 1426(c) affirmatively *required* Federal Home Loan Banks to redeem the shares of a member bank when that member requested a redemption and held the statutorily required number of shares. Although the legislative history is silent on why Congress made this change in 1961, we can only conclude that Congress made the change because it intended for Federal Home Loan Banks to have flexibility in handling redemptions.

Despite the statute, the IRS takes the position that the granting of redemption requests had become so routine at the Chicago Bank that, as a practical matter, shareholders did have an election to choose cash rather than stock. Without deciding whether the IRS's proposed standard for defining an "election" is the correct one, we conclude that the shareholders of the Chicago Bank did not have an election here. Having examined the record and all relevant facts, we are persuaded that the local officials of the Chicago Bank have not abdicated their obligation under the statutory directive of section 1426(c) to exercise discretion.

The Chicago Bank is, at present, one of eleven regional banks that operate under the supervisory and regulatory authority of the Bank Board, an independent federal agency. The Chicago Bank was created by the Bank Board "to accomplish federal objectives and is closely regulated in order to promote these objectives." *Fidelity Fin. Corp. v. Federal Home Loan Bank*, 792 F.2d 1432, 1435 (9th Cir. 1986), *cert. denied*, 107 S. Ct. 949 (1987). Those federal objectives are "to alleviate the pressing need of home owners for 'low-cost, long-term, installment mortgage money' and to 'decrease costs of mortgage money' with a 'resulting benefit to home ownership in the form of lower costs and more liberal loans.' " *Laurens Fed. Sav.*

& Loan Ass'n v. South Carolina Tax Comm., 365 U.S. 517, 522 (1961) (quoting H.R. Rep. No. 1418, 72d Cong., 1st Sess. 8-10; S. Rep. No. 837, 72d Cong., 1st Sess. 9-11). There is little doubt that Congress intended the public-at-large to be the beneficiaries of the Federal Home Loan Bank system. *Fidelity Fin. Corp. v. Federal Home Loan Bank*, 589 F. Supp. 885, 890 (N.D. Cal. 1983), *aff'd*, 792 F.2d 1432 (9th Cir. 1986).

The Bank Board, a federal agency, appoints six of the Chicago Bank's fourteen directors, it designates the Bank's chairman and vice chairman, and it has the power to suspend or remove any of the Bank's directors, officers, employees, or agents. 12 U.S.C. §§ 1427(g), 1437(a). Moreover, the Bank Board must approve all dividends issued by the Chicago Bank, and it retains the authority to prohibit a stock redemption, even if the Chicago Bank has approved the redemption. According to one court, this statutory scheme "reveal[s] an intention on the part of Congress to retain the broadest kind of federal control over the number, powers and existence of these purely legislative creatures." *Fahey v. O'Melveny & Myers*, 200 F.2d 420, 443 (9th Cir. 1952), *cert. denied*, 345 U.S. 952 (1953). That court also noted that funds handled by district banks "are used only in the performance of public and governmental functions," *id.* at 445, and that "a Federal Home Loan Bank is a federal instrumentality organized to carry out public policy and its functions are wholly governmental . . .," *id.* at 446.

We cannot say, on the basis of this record, that the officials of the Chicago Bank disregarded totally their statutory obligations. We notice, as did the Tax Court, that the directors of the Chicago Bank expressly enunciated the standards that would be evaluated when contemplating redemption applications. The Board's resolution instructed the Bank's day-to-day leadership to "be guided by all applicable statutory and regulatory provisions," and by "all policies and standards adopted from time to time by this Board . . . ." In view of that resolution and of the other facts mentioned, we are persuaded that the

shareholders of the Chicago Bank did not have an "election" to receive cash instead of stock.

We believe that the Tax Court resolved correctly the narrow issue presented to it. The officials of the Chicago Bank acted pursuant to federal statutory authority in determining whether to redeem stock tendered by individual banking institutions. This exercise of discretion pursuant to federal regulatory authority hardly vests in the shareholder banks an election to receive the dividend in cash rather than stock.

Conclusion

The decision of the Tax Court that early withdrawal penalties are not income by reason of the discharge of indebtedness is affirmed. The decision of the Tax Court that shareholders of the Chicago Bank did not have an election to receive cash instead of stock is affirmed.

AFFIRMED

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

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JUDGMENT – ORAL ARGUMENT

United States Court of Appeals

For the Seventh Circuit

Chicago, Illinois 60604

August 10, 1988

Before

Hon. WILLIAM J. BAUER, Chief Judge

Hon. KENNETH F. RIPPLE, Circuit Judge

Hon. HUBERT L. WILL, Senior District Judge*

COLONIAL SAVINGS ASSOCIATION AND SUBSIDIARIES,
Petitioners-Appellants,
Nos. 87-1021 and 87-1633
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee,
Cross-Appellant

FRONTIER SAVINGS ASSOCIATION AND SUBSIDIARIES,
Petitioner-Appellee,
Nos. 87-1499 and 87-1500
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Appeals from the United States Tax Court

This cause was heard on the record from the United States Tax Court, and was argued by counsel.

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* The Honorable Hubert L. Will, Senior District Judge for the Northern District of Illinois, sitting by designation.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the decision of the United States Tax Court in this cause appealed from, be and is hereby AFFIRMED, with costs, in accordance with the opinion of this Court filed this date.

COLONIAL SAVINGS ASSOCIATION and SUBSIDIARIES,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 25477-82
Filed November 26, 1985

P, a savings and loan association, was entitled to receive penalties from depositors because of premature withdrawals from their accounts. P generally credited depositors' accounts with compound interest on a daily basis. Depositors were entitled to withdraw the interest, but incurred a penalty if principal was withdrawn before maturity of the certificate. P contends that the penalties are income from the discharge of indebtedness within the meaning of sec. 108, I.R.C. 1954, and may be deferred in accord with Sec. 1017, I.R.C. 1954. Respondent agrees that the penalties are income to P, but contends that the penalties, which are reduced from the remaining principal and interest in the depositors' accounts, do not give rise to income from discharge of indebtedness. Held, the penalty for premature withdrawal does not give rise to income from discharge of indebtedness within the meaning of secs. 108 and 1017, I.R.C. 1954.

Robert A. Schnur, for the petitioners. Mark D. Peterson, for the respondent.

GERBER, Judge: Respondent determined a deficiency of $5,000 in petitioners' taxable year ended June 30, 1980. Due to an agreement of the parties,[1] the sole issue for our consideration is whether income received by finan-

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[1] Respondent determined several adjustments to the amounts reported by petitioners. For purposes of this opinion, however,

(Footnote continued on the following page)

cial institutions as penalties for premature withdrawal is to be treated as income from discharge of indebtedness within the meaning of section 108.[2] This is an issue of first impression.

FINDINGS OF FACT

All of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated by this reference. The factual pattern in this case is essentially the same as that presented in Rev. Rul. 83-60, 1983-1 C.B. 39, and respondent contends that the rationale of that ruling is dispositive of the issue before us.[3] We are, of course, aware that a revenue ruling merely represents the position of one of the litigants in this case, the Commissioner of Internal Revenue.

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1 *(Continued)*
the only issue for our consideration deals with cancellation of indebtedness. With respect to another pending issue, the parties in this case have agreed to be bound by the final decision in *Frontier Savings & Loan Association v. Commissioner*, docket No. 24559-83 (including any appeal thereof). Because of concessions by petitioners, a Rule 155 computation, Tax Court Rules of Practice and Procedure, will be necessary if respondent does not prevail in either of the remaining issues.

[2] All statutory references are to the Internal Revenue Code of 1954 as amended and in effect for the taxable year at issue.

[3] In pertinent part, the facts of Rev. Rul. 83-60, 1983-1 C.B. 39, are as follows:

FACTS
The taxpayer is a financial institution that issues savings certificates with terms of maturity varying from 6 months to 10 years. Federal regulations pertaining to these certificates require a holder to forfeit an amount as a penalty for withdrawal of the funds before the stated term of maturity. The amount of this premature withdrawal penalty is prescribed by the Depository Institutions Deregulation Committee (DIDC), which was established by the Depository Institutions Deregulation Act of 1980, section 203, 12 U.S.C. section 3502 (1980).

(Footnote continued on the following page)

Colonial Savings Association (petitioner), a Wisconsin savings and loan association organized on August 26, 1892, was owned by approximately 17,000 depositors as of June 30, 1980. Petitioner has two wholly owned subsidiaries; Brown County Service Corp., incorporated in 1975, and Colonial Financial Services, Inc., incorporated in 1976. References to petitioner in the singular will be to Colonial Savings Association. Petitioner's principal corporate office is in Green Bay, Wisconsin. Branch savings and loan offices are also maintained at several locations in Green Bay and Appleton, Wisconsin.

Petitioner, a cash basis taxpayer, timely filed a consolidated corporate income tax return (Form 1120) with the Internal Revenue Service Center, Kansas City, Missouri, for its taxable year ended June 30, 1980.

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3 *(Continued)*

The regulation provides a premature withdrawal penalty that may cause, in effect, a forfeiture of principal, as well as interest. If the deposited funds are withdrawn before the specified amount of interest is earned, or before it could have Abeen earned, then a portion of the principal must be forfeited to pay the prescribed penalty.

Under the taxpayer's contracts with its savings certificate holders, interest at a fixed rate is paid or credited to accounts of the holder either monthly or quarterly at the holder's option. The interest is withdrawable on demand and without penalty. The taxpayer's contracts also contain the terms of the penalties required by the above DIDC regulation for premature withdrawal. Should a holder incur a premature withdrawal penalty after withdrawing interest earned, a corresponding reduction is made in principal returned to the holder.

The taxpayer reported on its federal income tax return its income attributable to premature withdrawal penalties as income from the discharge of indebtedness under section 108 of the Code. Thus, the taxpayer excluded the amount of the penalties from its gross income and elected to reduce under section 1017 the basis of its depreciable property by the amount excluded.

When a depositor opened an account, petitioner provided the depositor with a certificate describing the account. If the depositor renewed the account, a new certificate was not issued, but petitioner sent a notice informing the depositor of any changes in the terms of the account. The parties have agreed that the certificates and notices of changes included terms that complied with all laws and regulations applicable to savings accounts at the time of issuance.

Petitioner's accounts included certificates with terms ranging from 3 months to 8 years.[4] Interest was compounded on these accounts on a daily basis with petitioner adding, on its computer records, the daily interest each day to the depositor's account.[5] With respect to petitioner's 6-month certificates, petitioner computed and added the interest to a depositor's account on a daily basis in the same manner as the other accounts, except that the interest was not compounded.

Some of the depositors' accounts were opened during petitioner's taxable year ended June 30, 1980. The remainder of the accounts were opened in prior years, and either the initial term had extended into or through petitioner's 1980 taxable year, or the initial term had expired on prior years, but the depositor had renewed the account at least once for a term extending into, or through petitioner's 1980 taxable year. Petitioner's total deposits were $106,383,872 at the beginning of its taxable year, and $123,617,503 on June 30, 1980, at the end of its taxable year.

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[4] Petitioner had the following types of accounts based on their maturities: 3-month, 6-month, 1-year, 2-year, 2-1/2-year, 3-year, 4-year, 6-year, and 8-year certificates.

[5] The amount of daily interest was computed by applying the applicable annual interest rate to the amount on deposit (including previously compounded interest) and then dividing the result by 360.

On any given day, a depositor could withdraw the principal balance in his account, plus the interest shown on petitioner's computer records as earned through such date, less any accrued interest that the depositor had already withdrawn. If a depositor requested the withdrawal of the principal in any account prior to maturity, the depositor was required, both pursuant to the terms of the certificates and Federal regulation,[6] to forfeit an amount as a penalty for withdrawal of the funds before the certificates reached maturity.[7] When a penalty for premature withdrawal was incurred, the depositor received a netted amount, composed of the principal on deposit plus interest payable to the date of withdrawal, less the penalty for premature withdrawal. The mandatory forfeitures were therefore "paid" by reducing the amounts payable to the depositor by the amount the depositor had agreed to pay and was required to forfeit.

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[6] The amount of premature withdrawal penalty has been prescribed by the Depository Institutions Deregulation Committee (DIDC) since July 31, 1980. Prior to that time, the Federal Home Loan Bank promulgated the regulations. For accounts opened or renewed after June 30, 1979, and before June 2, 1980, the regulations required the depositor to forfeit 3 months' interest on accounts with terms of 1 year or less and required the depositor to forfeit 6 months interest for accounts with terms exceeding 1 year. If the account was open for less than the 3-month or 6-month minimum penalty period, whichever was applicable, the depositor was required to forfeit all the interest. 12 C.F.R. sec. 526.7(a) (1979). For accounts opened or renewed after June 1, 1980, the depositor was required to forfeit all the interest which could have been earned, whether earned or not, for accounts with terms of less than 3 months. For accounts with terms from 3 months to 1 year, the depositor was required to forfeit 3 months' interest, whether earned or not. And for accounts with terms of more than 1 year, the depositor was required to forfeit 6 months' interest, whether earned or not. 12 C.F.R sec. 1204.103 (1981).

[7] The penalty for premature withdrawal may cause a forfeiture of principal as well as interest. Classification of whether interest or principal is being forfeited does not change the outcome of this case.

In no event did a depositor "pay" the forfeiture after first receiving the full amount due on a certificate.

Petitioner's books, for the period beginning July 1 to September 4, 1979, reflected the deduction of a net amount under section 591, comprised of gross interest accrued, less the amount of premature withdrawal forfeitures. Thus, petitioner treated the forfeitures during that period (in the amount of $8,024.04) as a reduction of its total interest deduction for that period. For the period beginning September 4, 1979, petitioner deducted the total amount of each day's interest as and when such interest was shown on petitioner's computer records. Petitioner treated the premature withdrawal forfeitures during this period as income from the discharge of indebtedness under section 61(a)(12) and excluded that amount from its gross income under section 108. Petitioner timely elected to treat the amount so excluded as a reduction in petitioner's basis of property under section 1017.

The total amount petitioner deducted during the taxable year ended June 30, 1980, after the offsets for early withdrawal forfeitures described above, was $10,372,635.95. The total amount forfeited by depositors due to early withdrawals from accounts on deposit was $600,744.88.

Petitioner contends that its method of handling the forfeitures prior to September 4, 1979, was incorrect. Petitioner believes that such method was incorrect because the forfeitures should always have been treated as income from discharge of indebtedness.[8]

OPINION

It is well settled that gross income means gross income from whatever source derived. Sec. 61(a). Gross income includes income from discharge of indebtedness. Sec. 61(a)(12). A taxpayer may realize income by paying an obligation at less than its face value. *United State v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931), revg. 71 Ct. Cl. 290, 44 R2d. 885 (1930); sec. 1.61-12(a), Income Tax Regs. For transactions occurring on or before December 31, 1980, however, no amount is included in gross income by reason of the discharge of any indebtedness for which a corporate taxpayer is liable if the taxpayer files a consent to the regulations prescribed under section 1017 relating to the adjustment of basis of property. Sec. 108.[9]

This is the first instance where a court has been asked to determine whether the receipt of premature withdrawal penalties is income from discharge of indebtedness within the meaning of sections 108 and 1017. Petitioner asserts that, but for section 108(a), these forfeited amounts would

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[8] Petitioner does concede, however, that it made certain errors in calculating the amount to be excluded and that, if the early withdrawal forfeitures do constitute income from discharge of indebtedness, the amount that should be excluded under sec. 108 is $591,896.36.

[9] The Bankruptcy Tax Act of 1980, Pub. L. 96-589, sec. 2(a), 94 Stat. 3389, amended sec. 108. For transactions occurring after Dec. 31, 1980, sec. 108(a) and (d)(4) provides that gross income does not include any amount which would be includable in gross income by reason of the discharge of indebtedness of the taxpayer if the indebtedness discharged is indebtedness incurred

(Footnote continued on the following page)

be includable in petitioner's gross income under section 61(a)(12). Respondent, on the other hand, asserts that not every indebtedness that is canceled results in gross income being realized "by reason of" cancellation of indebtedness. Rather, respondent argues that section 108 does not apply if the cancellation is simply the "medium" for payment. Respondent reasons that the penalty is a form of agreed upon or liquidated damages which the depositor has agreed to pay for the right to withdraw the funds at any time and to compensate the financial institution for lost profits, and thus the amount the depositor forfeits is simply the "medium" to pay this debt.

In addition, respondent argues that, pursuant to the contractual agreement between petitioner and depositors, petitioner was to be compensated if the funds were demanded early. The value of giving up the right to use the funds until maturity presumably equals the amount of the penalty and there was no cancellation of indebtedness because the financial institution received value equal in amount to the withdrawal penalty thus satisfying the debt in full. Petitioner counters that there was no payment and therefore there should not be any two-step analysis as respondent asserts. The statutes (sections 61(a)(12) and 108) are stark and undetailed. They cryptically provide that income from discharge of indebtedness is includable in gross income unless the taxpayer files a consent to defer

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9 *(Continued)*

or assumed by a corporation or an individual in his trade or business that makes an election under sec. 108(d)(4) with respect to the indebtedness.

Sec. 108 normally results only in postponement, rather than forgiveness, of taxable income by reducing the basis of depreciable assets under sec. 1017 and thereby assuring that the excluded income would reduce deductions from ordinary income in future years. Because the 1980 amendment applies in general only to transactions occurring after Dec. 31, 1980, the 1980 amendment does not apply to this case.

the income pursuant to section 1017. These statutes, until 1980 revision, have existed for over four decades without a definition of indebtedness or its cancellation. The gist of this case is whether the indebtedness (principal or interest) owed to the depositor has been "canceled" by means of the parties' agreement to reduce the indebtedness by the amount of a penalty for premature withdrawal of the indebtedness. More specifically, is this penalty a forgiveness, discharge, or cancellation within the meaning of sections 61(a)(12) and 108 and underlying case precedents? We hold that the forfeiture in this case is not a discharge of indebtedness within the meaning of the statutes and *United States v. Kirby Lumber Co.*, *supra*, and its progeny. As more fully discussed in the foregoing opinion, we find that the forfeiture was a separate and distinct obligation required of depositors for early withdrawal and not a forgiveness or discharge of the debt. The debt to the depositor was not canceled or discharged, it was simply reduced.

Prior to 1931, the Government was singularly unsuccessful in promoting the concept that income could be realized due to the discharge of indebtedness.[10] *Meyer Jewelry Co. v. Commissioner*, 3 B.T.A. 1319 (1926); *American Tobacco Co. v. Commissioner*, 20 B.T.A. 586, 588 (1930) (and cases cited therein). These cases focused upon the constitutional definition of income and the holdings of *Eisner v. Macomber*, 252 U.S. 189 (1920), and *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926).

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[10] In attempting to develop a historical perspective of this area of the tax law, we were confronted by a confusing line of precedent. A note commentator has also called it "One of the murkiest pools of obscurity in the tax law. . ." and suggested that "logic has taken an extended vacation in the debt cancellation area." Eustice, "Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion," 14 Tax L. Rev. 225, 286 (1959). Interestingly, that comment, although more than a quarter of a century old, is still true.

In 1931, however, the Government's position that income could be realized due to discharge of indebtedness met with success in *United States v. Kirby Lumber Co., supra.* The *Kirby* holding essentially rationalized that a reduction in debt (liabilities) without a corresponding reduction of assets causes income by unencumbering the assets and providing an economic gain or realizable event.[11]

The Government has managed to protect its *Kirby* win over the past 55 years with certain exceptions.[12] In situations where the cancellation of a debt was a gift or gratuitous act, courts have held that income from discharge of indebtedness did not occur. *Helvering v. American Dental Co.*, 318 U.S. 322 (1943); *Edmont Hotel Co. v. Commissioner*, 10 T.C. 260 (1948). But see *Commissioner v. Jacobson*, 336 U.S. 28 (1948). In a similar vein, courts have held that debt forgiveness by a shareholder-creditor is a contribution to capital, rather than income to the corporation due to the forgiveness of indebtedness. *Commissioner v. Fender Sales, Inc.*, 338 F2d 924, 930 (9th Cir. 1964), cert. denied 382 U.S. 813 (1965). In *Putoma Corp. v.*

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[11] *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), which was founded on the major premise that debt cancellation did not, in the constitutional sense, generate income was overruled or modified by *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), revg. 71 Ct. Cl. 290, 44 F2d 885 (1930). With respect to borrowing and repayment in the same foreign currency, the vitality of its holding is said to have been lost. *National-Standard Co. v. Commissioner*, 80 T.C. 551, 568 (1983) (Tannenwald, J., dissenting), affd. 749 F2d 369 (6th Cir. 1984). To the extent that the overall effect of the transaction produces a loss to the debtor, *Kerbaugh-Empire* retains some vitality. See *Vukasovich, Inc. v. Commissioner*, T.C. Memo. 1984-611, on appeal (9th Cir., Apr. 30, 1985).

[12] A relatively recent law review article provides a categorization and analysis of the exceptions to the *Kirby* holding. Powell, "A Review of Juudicial Exceptions to the Kirby Rule," 30 Fla. L. Rev. 94 (1977).

Commissioner, 66 T.C. 652, 6563-672 (1976), affd. 601 F.2d 734 (5th Cir. 1979), we analyzed the precedential relationship between the tax benefit rule, the *Kirby* holding, and the contributions to capital exception.

Another line of cases provides an exception to *Kirby* where there is essentially no indebtedness or the debt is contingent. An example of this exception involves a situation where a taxpayer satisfied an outstanding real property lien with municipal bonds purchased at a discount. *Hotel Astoria, Inc. v. Commissioner*, 42 B.T.A. 759 (1940). Because the Hotel Astoria was not "personally" responsible for the lien which attached to acquired real property, the Board reasoned that the hotel's use of discounted bonds "simply represented an additional investment. . . in the hotel property." (42 B.T.A. at 764.) Another example may be found in *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939), where the Board found the taxpayer's "liability" to be so indefinite and unfixed that it could not be canceled or otherwise reduced. (40 B.T.A. at 1265.) These exceptions tell us that there must be a liquidated debt and it must be the taxpayer's personal obligation in order for *Kirby* to apply.

Another exception to *Kirby* is where the evidence of indebtedness is merely reissued or modified and the underlying debt remains. *Tower Building Corp. v. Commissioner*, 6 T.C. 125 (1946). Here the debt had not been canceled, merely the evidence of it changed. The result might have been different if the par value of the new instrument or evidence of indebtedness was greater or less than that of the old.

Where the value of the asset falls below the balance of the debt it secures and the parties agree upon a reduction in the debt, another exception to *Kirby* has been carved. This exception seems to align with the *Kirby* rationale in that the reduction of the debt would release assets for the debtor's use. *Gehring Publishing*

Co v. Commissioner, 1 T.C. 345 (1942). Likewise, where the asset is voluntarily or involuntarily transferred to the holder of the secured indebtedness, the transaction is treated as a sale or exchange. *Electro-Chemical Engraving Co. v. Commissioner*, 311 U.S. 513 (1941); *Millar v. Commissioner*, 67 T.C. 656, 660 (1977), affd. 577 F.2d 212 (3d Cir. 1978).

It is helpful to understand the legislative background that preceded congressional enactment of sections 108 and 1017. Initially, following the Supreme Court's 1931 opinion in *Kirby*, relief was provided for bankrupt debtors in the form of a basis reduction. Bankruptcy Act of 1898, as amended by the Act of June 11, 1938 (Pub. L. 696, 52 Stat. 840), secs. 268 and 270. This type of relief was extended to insolvent debtors ("in an unsound financial condition") by section 215(a) of the Revenue Act of 1939. Secs. 22(b)(9), 113(b)(3), I.R.C. 1939. In 1942, the "unsound financial conditions" requirement was removed from section 22(b)(9), I.R.C 1939, because it denied benefits to many meritorious cases.[13] The provisions of sections 22(b)(9) and 113(b)(3), I.R.C. 1939, were reenacted into sections 108 and 1017 without significant change. It appears that the intended relief was to provide deferral of the recognition of realized income which has been "trapped" in assets and which may not be liquid. Initially, such relief was provided for bankrupts and insolvent entities where the recognition would cause acute hardship. In extending this relief to any taxpayer-debtor with income from discharge of indebtedness, Congress did not express an intent to expand the circumstances under which a discharge of indebtedness might occur. *Estate of Delman v. Commissioner*, 73 T.C. 15, 31-40 (1979).

Petitioner contends that the forfeiture, in the form of an "early withdrawal penalty," results in "income by rea-

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[13] Rept 1631, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 504.

son of the discharge of indebtedness" under section 108.[14] Petitioner argues that it satisfied a portion of its indebtedness by paying less to its creditor-depositors than the face amount of their debt. Because many of the depositors made the early withdrawal to take advantage of improved interest rates, petitioner sees a parallel to the original congressional purpose to provide relief from "changed economic conditions."[15]

Respondent's position, as set forth in Rev. Rul. 83-60, 1983-1 C.B. 39, and on brief is essentially that the depositors' early withdrawal triggering forfeiture is the "medium" for payment of a penalty which is used to reduce the amount of interest payable to the depositors. Stated another way, the penalty or forfeiture constitutes part of the payment of the interest credited to the depositors'

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[14] The parties have agreed (1) that petitioner has realized income, (2) that both the principal and interest reflected in depositors' accounts were "legally binding indebtedness," and (3) that petitioner has made a proper election. The sole dispute is whether the penalty or "forfeiture" constitutes discharge (cancellation or forgiveness) of indebtedness.

[15] Petitioner's attempt to bring the facts of this case within the original purposes and requirements for the predecessor of sec. 108 is inapposite. In this instance the creditor, not the debtor, is ostensibly attempting to improve his financial condition (investing his money at higher interest rates) rather than being subjected to unfavorable conditions, i.e., insolvency or reduction in value of assets. Moreover, petitioner does not appear to have an unsound financial condition or other unfavorable conditions. Petitioner had the use of depositors' funds and, by agreement (which was also pursuant to regulation), paid a net amount of interest which was less than originally agreed or no interest at all in some situations. Further, petitioner is permitted under sec. 591 to deduct the entire amount that had been credited to depositors' accounts without being required to make actual payment. At that juncture, petitioner seeks to defer the admitted resultant income by reporting the income as from discharge of indebtedness.

accounts and deducted by petitioner. Respondent's "medium" for payment position has also been referred to as a "spurious" cancellation of indebtedness.[16] "Spurious" cancellation, as defined by its authors, exists when "careful analysis discloses that the debt was not discharged for less than its face amount but was in fact fully paid." Bittker & Thompson, "Income From the Discharge of Indebtedness: The Progency of *United States v. Kirby Lumber Co.*," 66 Cal. L. Rev. 1159, 1174 (1978). The above-cited authors employ the following example of a "spurious" cancellation of indebtedness:

> if an employer lends $50 to an employee with the understanding that the debt will be deducted from the employee's next paycheck, the debt is paid in full on payday even though no cash changes hands and the transaction is formally termed a "cancellation." The employee must report $50 as income, not because the debt has been cancelled for less than its face amount within the meaning of *Kirby Lumber*, but because he has been paid in full for his services. (Bittker & Thompson, *supra* at 1174.)

Petitioner contends that it had "pure" and not "spurious" cancellation of indebtedness because no consideration passed from petitioner to the depositors for the discharge (forfeiture) as it had from the employee to the employer in the above-cited example. The parties[17] have focused their attention on whether there was one or two transactions between petitioner and each depositor. Ostensibly the parties must believe that it is necessary to have two sepa-

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[16] See Bittker & Thompson, "Income From the Discharge of Indebtedness: The Progeny of *United States v. Kirby Lumber Co.*" 66 Cal. L. Rev. 1159, 1174-1175 (1978).

[17] By an order dated Nov. 8, 1984, the United State League of Savings Institutions was granted leave to file briefs as amicus curiae. Its briefs have been considered regarding this and other aspects of this case. The briefs of the "League" solely support petitioner's position.

rate transactions or events to fall within the "spurious" cancellation area, i.e., indebtedness and separate consideration for its reduction, rather than discharge. Petitioner argues that its relationship with the depositors was solely that of debtor and creditor and the "forfeiture" constituted a discharge of the sole object of the relationship – the debt. Respondent, on the other hand, has ruled[18] that the depositor's liability for the penalty is contractual and also required by DIDC[19] regulations. Respondent's contention is that the forfeiture is "in the nature of agreed-upon fees or liquidated damages intended as both consideration for the early withdrawal privilege, and as compensation to the taxpayer for loss of the use of the deposited funds for the full term of the certificate."

We agree with both parties that the net effect of or the "forfeiture" itself causes the realization of income to petitioner. We disagree with petitioner, however, that this income is from the discharge of indebtedness. Section 108 only applies to "pure" cancellation of indebtedness income; it does not apply if the debt forgiveness is simply the method by which a creditor makes a payment to a debtor. *OKC Corp. & Subsidiaries v. Commissioner*, 82 T.C. 638, 649 (1984); *Spartan Petroleum Co. v. United States*, 437 F. Supp. 733, 737 (D.S.C. 1977); Bittker & Thompson, *supra* at 1186.

In this case petitioner and each depositor agreed, in substance, as follows: Petitioner agreed to pay interest at a fixed rate and on certain dates if the depositor agreed to deposit an amount of money for a fixed peri-

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[18] Rev. Rul 83-60, 1983- 1 C.B. 40-41.

[19] DIDC (Depository Institutions Deregulation Committee) was established by the Depository Institutions Deregulations Act of 1980, sec. 203, 12 U.S.C. sec. 3502 (1980).

od. The depositor agreed to be subject to a penalty[20] if withdrawals, below a minimum balance requirement, occurred at certain times prior to maturity of the certificate or account. Petitioner, pursuant to section 591, deducted the entire amount of interest accrued in each depositor's acccount, without reduction for the penalties or forfeitures.[21] This factual pattern does not give rise to cancellation or discharge of the debt. The debt (interest) was credited to the depositor's account and (subsequent to September 4, 1979) deducted in full by petitioner.[22] The depositor was subject to a penalty, depending upon the extent of prematurity of withdrawal, which would either reduce or completely eliminate the interest credited. Further, the depositor may have the principal subjected to the penalty depending upon the prematurity of withdrawal and/or the amount of interest withdrawn from the account. In sum and substance, the debt (which includes both interest and principal)[23] has not been discharged, cancelled, or

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[20] The certificates issued by petitioner contained "Penalty Clause Section(s)" and the text of these sections referred to a "penalty," whereas the DIDC regulations refer to a "forfeiture." The parties have used the terms "penalty" and "forfeiture" interchangeably in their stipulation of facts and briefs and we have not placed any significance upon the use of these particular terms.

[21] Up until Sept. 4, 1979, and for all prior years, petitioner reduced the gross amount of interest shown in depositors' accounts by the amount of penalties of forfeitures for the same period. Following Sept. 4, 1979, through the conclusion of its taxable year ended June 30, 1980, petitioner did not reduce the gross amount of interest reflected in depositors' accounts by the amount of forfeitures for that same period. This change in approach by petitioner coincides with the change to the regulations, to some extent, as reflected in note 6, *supra*. In any event, petitioner contends that its treatment of the forfeitures prior to Sept. 4, 1979, was in error.

[22] See note 16, *supra*.

[23] The parties agree that both interest and principal in the accounts are the basis for a debtor-creditor relationship between the petitioner and depositors.

forgiven. The penalty or forfeiture was an obligation of the depositor, which petitioner and depositor agreed, in advance, could be satisfied from interest credited or principal deposited in the account.

Respondent has treated consistently the subject of premature withdrawal in regulations and rulings. The obligation to supply depositors with annual information returns, Forms 1096 and 1099-INT, was published in 1973 and required institutions to reflect the full or gross amount of interest credited or paid, unreduced by any penalty or forfeiture for premature withdrawal. Rev. Rul. 73-511, 1973-2 C.B. 402, 403. The rationale of that ruling, in part, relied upon the difference in treatment of the penalty by recipients. In effect, the interest credited was income to the depositor and the penalty deductible as a loss under section 165. If incurred in a trade or business, the loss may be a deduction from gross income, but for some taxpayers the loss may be available only if deductions are itemized. The regulations under section 1017, which were originally filed in 1956, treat payments in kind as discharges affecting basis only to the extent that the value of the payment was less than the reduction of the indebtedness. Sec. 1.1017-1(b)(5), Income Tax Regs.

The need for relief from (deferral of) income from discharge of indebtedness, congressionally considered in the enactment of sections 108 and 1017 and their predecessors, is not present in this case. Here, petitioner's relief would seem to be the penalty for early withdrawal received from the depositor. Petitioner has had the use of depositors' funds, a full tax deduction for interest credited and not necessarily paid,[24] and a penalty to compensate petitioners for any hardship caused by the early withdrawal. In

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[24] Because a certificate may not mature prior to the end of petitioner's taxable year, petitioner may have enjoyed some deferral

(Footnote continued on the following page)

comparison to the Kirby principle, there has not been an increase in the value of assets attributable to a reduction in liabilities. In this case, petitioner has been compensated by depositors' payments of penalties. *Estate of Delman v. Commissioner, supra; OKC Corp. & Subsidiaries v. Commissioner, supra; Spartan Petroleum Co. v. United States, supra.*

Petitioner cites three cases in support of its petition. One of these cases has a factual pattern with some similarities to this case. In *Reliable Incubator & Brooder Co. v. Commissioner*, 6 T.C. 919, 926-927 (1946), the taxpayer was obligated to make $50 monthly payments toward an outstanding and fixed obligation approximating $6,700. At a time when the taxpayer's creditor was in need of money, the parties agreed to reduce the outstanding debt by $1,200 in exchange for a $600 payment by the taxpayer in advance of the monthly due dates. On these facts we decided that there was $600 of income from discharge of indebtedness to the taxpayer, but that the deferral relief was not available because of the taxpayer's failure to file a consent and the taxpayer was not insolvent or in an "unsound financial condition."[25] Although petitioner in this case has filed a timely and proper consent, the facts of this case do not coincide with those in *Reliable Incubator*. Petitioner here was indebted for interest (and principal) and part or all of its indebtedness was "paid" or offset by the depositors' obligation for a penalty attributable to premature withdrawal. Stated another way, the debtor's accumulated interest was essentially used to pay the penalty on a dollar-for-dollar or par basis. The parties in *Reliable Incubator*

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24 *(Continued)*
without secs. 108 and 1017. The penalty may fall into a subsequent year and not have the tax effect of "washing out" in the same taxable period.

[25] The "unsound Financial condition" requirement was removed in 1942.

entered into a "two-for-one" reduction in indebtedness so that each dollar paid provided an additional "dollar of forgiveness" of the debt. Only the additional dollar or credit (the "forgiveness dollar") was found to be income from discharge of indebtedness. *Reliable Incubator & Brooder Co. v. Commissioner*, 6 T.C. 919, 926-927. To the same effect, petitioner has cited a Memorandum Opinion of this Court which followed *Reliable Incubator*. *San Marcos Hotel Co. v. Commissioner*, a Memorandum of Opinion of this Court dated April 18, 1852. A third and final case cited by petitioner falls in a similar category with *Reliable Incubator* because it involves a conversion of debt into equity instruments and accrued interest was disregarded at the time of conversion. *Columbia Gas Systems, Inc. v. United States*, 473 F.2d 1244, 1249-50 (2d Cir. 1973). The issuer of the debt was found to have income from discharge of indebtedness to the extent of interest disregarded at the time of conversion. Again, unlike the facts in the case before us, the disregarding of the interest at the time of conversion represents a classic application of *Kirby*. Although it could be said that the parties bargained for that result, there is no indication that the bondholder received or was relieved of anything in exchange for the discharged indebtedness.

We understand and do not disapprove of petitioner's attempt herein to arrange its tax matters efficiently and seek deferral of income from the depositors' penalties. We find, however, that the facts herein do not support the result petitioner seeks.

In view of the foregoing,

An appropriate order will be entered finding for the respondent on the issue presented in this case.

UNITED STATES TAX COURT

COLONIAL SAVINGS ASSOCIATION AND SUBSIDIARIES, *Petitioners*, *v.* COMMISSIONER OF INTERNAL REVENUE, *Respondent*	Docket No. 25477-82

DECISION

Pursuant to the opinion of the Court filed in this case on November 26, 1985, the Order of this Court dated October 29, 1986, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is an overpayment in income tax due to the petitioners for the taxable year ended June 30, 1980 in the amount of $18,235.00, of which amount $5,000.00 was paid after the mailing of the notice of deficiency; and $13,235.00 was paid on May 17, 1982, and for which amount a claim for refund could have been filed, under the provisions of IRC 6511(b)(2), on September 29, 1982, the date of the mailing of the notice of deficiency.

Joel Gerber
Judge

Entered: DEC 19 1986

UNITED STATES TAX COURT
Washington, D.C.

COLONIAL SAVINGS ASSOCIATION AND SUBSIDIARIES, *Petitioners,* *v.* **COMMISSIONER OF INTERNAL REVENUE,** *Respondent*	Docket No. 25477-82

ORDER

Pursuant to the determination of this Court in its Opinion (85 T.C. 855), filed November 26, 1985, one of two controvered issues in this case was resolved in respondent's favor (adjustment (a), Schedule 1-A, page (3), of the statutory notice of deficiency mailed to petitioner July 29, 1982, and adjustments (b) and (c), which follow adjustment (a) for computational purposes). The parties, by a stipulation, dated September 17, 1984, as amended October 17, 1986, have stipulated that the remaining controverted issue (as contained in adjustment (d), Schedule 1-A, page (3), of the statutory notice of deficiency mailed to petitioner July 29, 1982) is factually the same (other than the number or shares of stock involved, a fact the parties concede is of no effect) as adjustment 1.a. contained in the statutory notice of deficiency of Frontier Savings and Loan Association, which was the single issue addressed and determined in *Frontier Savings and Loan Association v. Commissioner*, 87 T.C. No. 40, filed September 24, 1986. Further, the parties have stipulated that we should adopt the holding in *Frontier Savings and Loan Association, supra*, so as to find in favor of petitioner on that issue. The parties have further stipulated that the amount of respondent's determination in adjustment (d), Schedule 1-A, page (3), of the statutory notice of deficiency mailed to petitioner July 29, 1982, is correct. Wherefore, it is

ORDERED that adjustment (d), Schedule 1-A, page (3), of the statutory notice of deficiency mailed to petitioner July 29, 1982, is in error, as alleged in the petition herein and that petitioner is not required to include $61,900 of dividends in income for its taxable year ended June 30, 1980, as previously determined by respondent. This holding is pursuant to the parties' stipulation and in accord with our holdings in *Frontier Savings and Loan Association, supra*, the rationale of which is adopted herein by this reference. It is further

ORDERED that pursuant to the determination of this Court in its Opinion (85 T.C. 855), filed November 26, 1985, the holding set forth in this order and concessions of the parties, decision will be entered under Rule 155 of the Rules of Practice and Procedure of this Court.

Joel Gerber
Judge

Dated: Washington, D.C.
October 29, 1986

In The
United States Court of Appeals
For the Seventh Circuit

Chicago, Illinois 60604

September 13, 1988

No. 87-1012, 87-1663

COLONIAL SAVINGS ASSOCIATION and SUBSIDIARIES,
Petitioners-Appellants,
Cross-Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee,
Cross-Appellant.

Appeals from the United States Tax Court.
Honorable William J. Bauer, *Chief Judge*
Honorable Kenneth F. Ripple, *Circuit Judge*
Honorable Hubert L. Will, *Senior District Judge*[*]

ORDER

On consideration of the petition for rehearing and suggestion for rehearing en banc filed on the above numbered appeals by petitioners-appellants, Colonial Savings Association and subsidiaries, on August 24, 1988, no judge in active service has requested a vote thereon, and all of the judges on the original panel have voted to deny a rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.

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[*] The Honorable L. Will, Senior District Judge for the Northern District of Illinois, sitting by designation.

(2)

No. 88-1003

Supreme Court, U.S.
FILED
FEB 23 1989
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL SAVINGS ASSOCIATION AND SUBSIDIARIES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether income received by a financial institution from its depositors as penalties for early withdrawal is excludable from gross income as income from "the discharge * * * of indebtedness," within the meaning of Section 108 of the Internal Revenue Code.

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In the Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-1003

COLONIAL SAVINGS ASSOCIATION AND SUBSIDIARIES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A25) is reported at 854 F.2d 1001. The opinion of the Tax Court (Pet. App. A25-A46) is reported at 85 T.C. 855.

JURISDICTION

The judgment of the court of appeals (Pet. App. A26-A27) was entered on August 10, 1988. A petition for rehearing was denied on September 13, 1988 (Pet. App. A50). The petition for a writ of certiorari was filed on December 12, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner Colonial Savings Association is a Wisconsin savings and loan association.[1] During its taxable year ended June 30, 1980, petitioner had outstanding various types of savings accounts with differing terms. Interest on these accounts was computed and added to the depositors' accounts on a daily basis. A depositor was free at any time to withdraw the principal balance in his savings account, plus the interest earned through that day. Some of petitioner's accounts, commonly known as "certificates," guaranteed a fixed interest rate for a specified term of years. Federal regulations required depositors to pay a penalty to petitioner if they withdrew the principal balance of such certificates prior to maturity. See 12 C.F.R. 526.7 (1980); 12 C.F.R. 526.7 (1979) (*reprinted in* Pet. App. A4 n.3). Under the terms of the account agreements, this early withdrawal penalty was paid by reducing the amount payable to the depositor. Pet. App. A3-A4, A30-A33.

During the tax year in issue, petitioner received $600,745 in early withdrawal penalties (Pet. App. A33). Petitioner treated the penalties as income from the discharge of indebtedness that was excluded from gross income under Section 108 of the Internal Revenue Code.[2]

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[1] For convenience, we will use the term "petitioner" to refer to petitioner Colonial Savings Association.

[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the taxable year in issue. Section 108 generally provided that no amount is included in gross income by reason of the discharge of indebtedness if the taxpayer made an election under Section 1017 of the Code to reduce the basis of other property. Petitioner made the necessary election (Pet. App. A33). Section 108 was amended in 1986 to limit its application to cases where the taxpayer is insolvent or the discharge occurs in a bankruptcy case, but that amendment is not applicable to the years at issue here. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2373 § 822(a); Pet. App. A8 n.5.

The Commissioner determined that the penalties did not constitute income by reason of the discharge of indebtedness within the meaning of Section 108 and therefore had to be included in petitioner's gross income. Petitioner sought redetermination of the resulting deficiency in the Tax Court. Pet. App. A3, A33.

2. The Tax Court held that the early withdrawal penalties did not constitute income from the discharge of indebtedness (Pet. App. A28-A46). The court observed that a debtor does not have income from the discharge of indebtedness "if the debt forgiveness is simply the method by which a creditor makes a payment to a debtor" (Pet. App. A42). The court concluded that "[t]he penalty or forfeiture was an obligation of the depositor, which petitioner and [the] depositor agreed, in advance, could be satisfied from interest credited or principal deposited in the account" (*id.* at A44). Since the indebtedness "was essentially used to pay the penalty" (*id.* at A45), the debt was satisfied, not discharged, and Section 108 was inapplicable.

The court of appeals unanimously affirmed (Pet. App. A1-A25). The court observed that "when the discharge of indebtedness is a mere medium for the payment of a separate obligation between two parties, section 108 does not apply" (*id.* at A9). Rejecting petitioners' contention to the contrary, the court of appeals' analysis of the nature of early withdrawal penalties led it to conclude that they "represent separate obligations from depositors to [petitioner]" (*id.* at A13). The purpose of the penalty, the court observed, is "to compensate the bank-debtor for the harm" caused by the depositor's withdrawal of the funds prior to the agreed term; the penalty "is a form of liquidated damages for the added expense that the bank must suffer in an effort to procure the funds that have been lost" (*id.* at A11). Although the income produced by the penalty arose out of a debtor-creditor relationship, the

court concluded that the income "did not arise 'by reason of the discharge of indebtedness.' Rather, it arose by reason of the creditor's alteration of the parties' contract and the consequential expenses of the bank/debtor" (*id.* at A11-A12). The court also noted that the special action taken by Congress with respect to the tax treatment of a depositor who pays an early withdrawal penalty indicated its view that the depositor's obligation to pay the penalty is separate from the financial institution's obligation to repay principal plus interest (*id.* at A12-A13).

ARGUMENT

Petitioners contend that the amount of the early withdrawal penalties paid by its depositors was income realized from the discharge of indebtedness within the meaning of Section 108 of the Code. This contention was correctly rejected by both courts below. Moreover, the decision below does not conflict with any decision of another court of appeals or of this Court.[3] Accordingly, there is no reason for further review.

Petitioners do not dispute that the early withdrawal penalties in issue are income. The question presented is whether they are a particular type of income that qualifies for special treatment under Section 108 of the Code. That section generally provides that income realized "by reason of the discharge * * * of indebtedness" may be excluded

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[3] There is no merit to petitioners' suggestion (Pet. 8-10) that this case should be held because the same issue is pending in another case on the government's appeal in the Fifth Circuit. See *Centeni ial Savings Bank FSB* v. *United States*, 682 F. Supp. 1389 (N.D. Tex. 1988), appeal pending, (No. 88-1297). There is no reason to anticipate that the Fifth Circuit will disagree with the decisions of the Tax Court and the Seventh Circuit here. If a conflict in the circuits ever does develop on the question presented here, the Court can consider at that time whether certiorari is appropriate in those circumstances.

from gross income if the taxpayer elects under Section 1017 to reduce its basis in property it owns in an amount equal to the amount excluded. The effect of these provisions is to permit deferral of the tax on the debt discharge income; the tax is ultimately collected indirectly because the taxpayer must take lower depreciation deductions for the reduced-basis assets or recognize greater gains on their sale. As the court of appeals observed (Pet. App. A7-A8), the purpose of Section 108 was to grant relief from immediate taxation to taxpayers who strengthen their financial position on paper through debt reduction. The legislative history of Section 108 indicates that Congress was responding to the concern that current taxation of the resulting income might discourage a debtor from reducing its debt, because the transaction did not produce assets that could be used to pay the tax. S. Rep. No. 1631, 77th Cong., 2d Sess. 45-46, 77-78 (1942); H.R. Rep. No. 855, 76th Cong., 1st Sess. 5 (1939); 97 Cong. Rec. 3796 (1951) (statement of Rep. Camp).

It is well established that a taxpayer can realize income from the discharge of a debt when the debt is forgiven, cancelled, or otherwise discharged for less than its face amount. See *Commissioner* v. *Jacobson,* 336 U.S. 28, 38-40 (1949); *United States* v. *Kirby Lumber Co.,* 284 U.S. 1 (1931). But not every debt that is cancelled or discharged results in income "by reason of the discharge" of the debt within the meaning of Section 108. If the cancellation of a debt is not, in and of itself, the source of the income, but simply the method by which a creditor makes a payment to a debtor, then the debtor does not have income "by reason of" a debt discharge; he has income "by reason of" receiving a payment. Such income does not qualify for the Section 108 exclusion. See *OKC Corp.* v. *Commissioner,* 82 T.C. 638, 647-649 (1984); S. Rep. No. 1035, 96th Cong., 2d Sess. 8 n.6 (1980). The Tax Court (Pet. App.

A42-A46) and the court of appeals (*id.* at A9-A13) correctly held that the income received by petitioner from the early withdrawal penalties paid by its depositors is governed by this principle.

Federal regulations require a depositor to pay a penalty to petitioner in order to withdraw the principal from one of petitioner's fixed-term accounts prior to maturity. Petitioner collects these penalties for early withdrawal by reducing the amount otherwise payable to the depositor. If instead the depositor had paid the penalty to petitioner in cash and in turn received the entire amount due on the certificate, petitioner would have had income in the amount of the penalty and that income clearly would not have been income from the discharge of indebtedness. The result should be no different where, as here, the method of paying the penalty is by reducing the amount turned over to the depositor. Petitioner did not have income "by reason of" the discharge of indebtedness; it had income "by reason of" receiving a penalty.

Income from the discharge of indebtedness is realized where a debt is discharged for less than its face amount, *i.e.*, where all or a portion of the debt is forgiven. Here, although the debt owed to a depositor was "discharged" in the sense that it was extinguished, it was not discharged for less than face value. The portion of the debt that petitioner did not pay to the depositor was not forgiven by the depositor, but rather was used to satisfy—*i.e.*, to pay—the penalty obligation owed by the depositor. As the court of appeals concluded, "early withdrawal penalties represent separate obligations from depositors to [petitioner]" (Pet. App. A13), and therefore they are not encompassed within Section 108 of the Code.

Petitioners' objections to the court of appeals' analysis are unavailing. First, their assertion (Pet. 12-13) that the instant case is indistinguishable from *United States* v.

Kirby Lumber Co., supra, is mistaken. In *Kirby Lumber,* the taxpayer issued bonds for which it received their par value. The bonds declined in value, and the taxpayer later purchased some of the bonds on the open market at less than par value. This Court held that the taxpayer had realized income from the discharge of indebtedness. See 284 U.S. at 3. The transaction involved in *Kirby Lumber* is quite unlike the transaction here. The bondholders in *Kirby Lumber* had no separate obligation to the taxpayer, nor did they receive anything in exchange for the discharged debt. Here, by contrast, the savings certificate agreement and federal regulations imposed a fixed obligation on the depositors, and that obligation was satisfied by the reduction of the amount paid to them on their certificates. Petitioners' reliance (Pet. 13 n.9) on *Columbia Gas System, Inc.* v. *United States,* 473 F.2d 1244 (2d Cir. 1973), is misplaced for the same reason. In *Columbia Gas,* some of the taxpayer's convertible bonds were converted into stock, and the penalty for that conversion under the terms of the bonds was forfeiting the accrued interest on the bonds. The bondholders had no separate obligation to the taxpayer and did not receive anything in exchange for the discharged interest debt.

More generally, petitioners contend (Pet. 11-12) that the income here must be encompassed within Section 108 because the penalty was not a "separate and distinct" obligation of the depositor to petitioner. But the fact that the penalty obligation arose under a provision of the savings certificate agreement (which was required by federal regulations)—*i.e.,* the fact that there was only one *contract* between petitioner and an individual depositor—does not mean that there was only one *obligation* between petitioner and that depositor. Petitioner owed the depositor money as part of the traditional relationship between a debtor-bank and creditor-customer. With respect to the

penalty, on the other hand, the depositor was the debtor owing money to petitioner. The depositor's obligation to pay the penalty was a separate aspect of the parties' relationship.

The court of appeals also was correct in noting (Pet. App. A12-A13) that the specific actions taken by Congress in connection with early withdrawal penalties, and its failure to take any action to provide financial institutions with the income tax treatment that petitioner seeks, support the conclusion that income from early withdrawal penalties is not covered by Section 108. In Rev. Rul. 73-511, 1973-2 C.B. 402, the Commissioner ruled that a depositor who pays an early withdrawal penalty out of interest earned on the account may not reduce his interest income by the amount of the penalty, but rather must report the full amount of interest earned on the account; he may then deduct the amount of the penalty as a loss under Section 165 of the Code. The ruling was based on the rationale that the interest and the penalty represent separate transactions. The ruling further concluded that the loss would, in the case of an individual depositor, generally be considered as a loss "incurred in any transaction entered into for profit, though not connected with a trade or business," as described in Section 165(c)(2). One of the consequences of this determination was that the loss could be claimed as a deduction only by a taxpayer who itemizes deductions.

Congress was troubled by the proposition that taxpayers who used the standard deduction could not deduct their early withdrawal penalties. Accordingly, it amended the Code to provide that the deduction for early withdrawal penalties would be allowable in arriving at adjusted gross income, thus allowing non-itemizers to claim the deduction as well. See Sec. 6(a) of the Act of Oct. 26, 1974, Pub. L. No. 93-483, 88 Stat. 1458-1459 (current version codi-

fied at 26 U.S.C. § 62(a)(9) (Supp. IV 1986)). Congress did not, however, disapprove the Commissioner's conclusion that interest and early withdrawal penalties are separate and distinct obligations; to the contrary, the legislative history of the amendment clearly supports that position. See H.R. Conf. Rep. No. 1405, 93d Cong., 2d Sess. 5 (1974); 120 Cong. Rec. 28117 (1974) (statement of Sen. Church). Indeed, the Conference Report describes Rev. Rul. 73-511 as embodying "present law" (H.R. Conf. Rep. No. 1405, at 5), and the amendment did not change the law with regard to the treatment of interest and penalties as separate obligations.

Petitioners complain (Pet. 16) that the court of appeals relied too heavily on "Congressional 'silence' " with respect to the tax treatment of financial institutions that receive early withdrawal penalties. But the court of appeals primarily relied not on "silence" but on Congress's considered response to Rev. Rul. 73-511.[4] And the court invoked this congressional action merely to confirm its correct conclusion that the penalty is a separate obligation—a conclusion that was independently based on the nature of the penalty (see Pet. App. A9-A12). Since that penalty obligation is separate from the financial institution's obligation to the depositor on the savings certificate, petitioner's receipt of the penalties did not amount to income "by reason of the discharge * * * of indebtedness."

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[4] Petitioners also place undue reliance (Pet. 15-16) on the fact that Rev. Rul. 73-511 discussed a situation in which the depositor paid the penalty out of interest. Nothing in the ruling, or in the nature of the penalty, suggests that the result would be different where the penalty is paid in part out of principal.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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Supreme Court of the United States

October Term, 1988

COLONIAL SAVINGS ASSOCIATION and SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF OF PETITIONERS

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REPLY BRIEF OF PETITIONERS

ARGUMENT

I. The Commissioner's argument that this Court should not take into account the pendency of the *Centennial* appeal ignores the potential economic impact of such a step on financial institutions in the Seventh Circuit.

In their Petition, the Petitioners noted (Pet. p. 8) that the decision of the Court of Appeals in this case is directly contrary to the decision reached by Acting Chief Judge Sanders in *Centennial Savings Bank FSB v. United States*, 682 F. Supp. 1389 (N.D. Tex. 1988), and that the latter

decision is now on appeal by the Government to the Court of Appeals for the Fifth Circuit (Appeal No. 88-1297). The Petitioners therefore suggested that this Court should defer any decision with respect to the instant Petition until the Fifth Circuit has decided the *Centennial* appeal; then, if the Fifth Circuit upholds the District Court, there will be a direct conflict between the two Circuits which this Court might well decide to resolve.

The Commissioner responds that there is "no merit" to this suggestion because "[t]here is no reason to anticipate" that the Fifth Circuit will affirm the District Court in *Centennial* and that, if it does, this Court can then consider whether certiorari is appropriate in that other proceeding. (Brief in Opposition, p. 4).

The Commissioner's response to Petitioner's suggestion is inappropriate and disappointing. As the Commissioner well knows, his "solution" to the problem has as its only advantage the potentiality of generating significant unjustified tax revenues for the Treasury. If the Commissioner's "solution" were adopted, a significant possibility would arise that savings institutions located in states comprising the Seventh Circuit would be forced to bear a substantial tax burden for past years not shared by institutions located in other jurisdictions.[1] Conversely, if this Court were to accept the Petitioner's suggestion and defer action on the instant Petition until the Fifth Court has had an opportunity to decide *Centennial*, this Court (without increasing its own burden in any respect whatsoever) could then act with assurance that the ultimate resolution of this highly important issue will apply nationwide. This Court can surely take judicial notice of the troubled state of the savings industry and Petitioners respectfully sug-

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[1] This would occur if (i) the instant Petition were denied, (ii) the Fifth Circuit affirmed the District Court's decision in *Centennial* and (iii) that affirmance was either not appealed by the Government or was appealed and upheld by this Court.

gest that this Court, merely by deferring consideration of the instant Petition for a short additional period, can avoid introducing another substantial destablizing factor into an already unstable industry.

II. The Commissioner has failed to distinguish *Columbia Gas System* from the instant case.

The petitioners have also pointed out (Pet. p. 13) that the decision of the Court of Appeals in the instant case is in direct conflict with the decision of the Second Circuit Court of Apeals in *Columbia Gas System, Inc. v. United States*, 473 F.2d 1244 (2d Cir. 1973). The Commissioner attempts to minimize this conflict by distinguishing *Columbia Gas System* on its facts (Brief in Opposition, p. 7) but, although the two cases involve different industries, they present the same precise issue.

In *Columbia Gas System*, the taxpayer had issued debentures with a fixed interest rate and maturity date; the debentures could be converted into stock of the issuer at the election of the debenture holder but, in the event of such a conversion prior to the debenture maturity date, the holder would be required to forfeit a portion of the interest due to it under the terms of the instrument. The Second Circuit held that the income generated to the issuer as a consequence of the interest forfeiture was income arising "by reason of the discharge . . . of indebtedness" under I.R.C. §108, which income could have been deferred if the taxpayer had made a timely election to do so. As can be seen, this result is in direct conflict with the holding of the Court of Appeals in the instant case and, on that basis alone, this Court should accept the instant Petition.

The Commissioner, however, attempts to distinguish *Columbia Gas System* with the following analysis (quoted in its entirety):

> "In *Columbia Gas*, some of the taxpayer's convertible bonds were converted into stock and the

> penalty for that conversion under the terms of the bonds was forfeiting the accrued interest on the bonds. The bondholders had no separate obligation to the taxpayer and did not receive anything in exchange for the discharged interest debt."

Brief in Opposition, p. 7. These statements may be true[2] but they apply as well to the transactions at issue in the instant case. Thus, just as there was in *Columbia Gas System* a so-called "penalty" for converting a debenture prior to its maturity, there was in the instant case a so-called "penalty" for prematurely withdrawing a savings account. And just as this "penalty" in *Columbia Gas System* was to be statisfied by "forfeiting the accrued interest on the bond," the "penalty" in the instant case was to be satisfied by a forfeiture of accrued interest on the account. Finally, just as there were no "separate obligations" owed by the debenture holders to the taxpayer in *Columbia Gas System* (since the so-called "penalty" arose out of and only because of the premature conversion), there was for the same reason no "separate obligation " owed by an account holder to the taxpayer in the instant case.[3] In

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[2] It is, though, impossible to understand the meaning of Commissioner's contention that in *Columbia Gas System*, the debenture holders "did not receive anything in exchange for the discharged interest debt." The benefit received by the holders was the right to convert their bonds prior to maturity or, in other words, to change their investment into an instrument with a greater potential return. Obviously, this was the economic benefit that motivated their decision to accept the "penalty" of forfeiting the interest otherwise due to them. In the instant case, of course, the account holders acted with precisely the same motivation and accepted the same penalty therefor.

[3] The Commissioner (Brief in Opposition, p. 7) mistates Petitioner's argument (that there was no "separate obligation" between the taxpayer and its depositiors) as resting on the sole fact that there was only one "contract" between them. This, however, is only one relevant factor. More significant is the fact that the so-called "separate obligation" (that is, the penalty)

(Footnote continued on the following page)

short, the Seventh Circuit in this case and the Second Circuit in *Columbia Gas System*, faced with the same issue, reached opposite results and the Commissioner has failed to demonstrate any relevant distinction between the two cases.

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3 *(Continued)*
arose only in, and because of, the very transaction in which the debt forgiveness occurred; in all the other "separate obligation" cases cited by the Commissioner, the obligation owed by the debt holder to the taxpayer arose in an entirely separate transaction between the parties and, if it had not been satisfied by the debt forfeiture, it would have had to be paid in some other manner.

CONCLUSION

For the reasons stated herein and in the initial Petition, this Court is again respectfully requested to (i) delay taking any action with respect to this Petition until the Fifth Circuit Court of Appeals has decided the *Centennial* case and (ii) in any event, grant this Petition.

Respectfully submitted,

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